The Federal Budget Surplus: Surprise or Strategy?

By the Certified General Accountants Association of Canada

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Foreword

The budget is one of the most important and visible documents fashioned by the federal government. It embodies extensive tax and spending policy decisions and, as such, reflects its interpretation of the economy's prospect. At the same time, it serves also to signal to society and to the marketplace. Moreover, the budget has the ability to invoke significant consequences, intentionally or otherwise, onto the economic and social welfare of the public and of commerce.

But as federal budget deficits have increasingly become a condition of the past, so too has the observable concern of the general public over budgetary balance. With an 11-year record of repeat budgetary surpluses boosting confidence in the soundness of public finances, there is seemingly little cause for the general population to receive the budget exercise as possibly anything but complex, overwhelming, redundant or even boring. Moreover, there is certain apathy within the Canadian fabric as the electorate attempts to decipher policy dimensions from political banter. Generally speaking, public interest in the federal budget mounts twice a year; when it is tabled (usually in February – March), and, when announcing economic and fiscal update (usually in October – November). We may also witness renewed interest when unanticipated announcements on new policy initiatives are made. Interestingly though, this attention has primarily been mobilized over the past several years by speculative behaviour around fiscal incentives the government may have to offer the public. Of course, potential calls for an election can also attract budget debate as is the case at the time of writing of this paper.

With a particular curiosity around how public Canada emerged into an era of fiscal surplus, the Certified General Accountants Association of Canada (CGA-Canada) set out to better understand the fiscal process and to impart that insight to everyday Canadians. With that goal in mind, we would premise the following pages with an acknowledgement that Canada is not on the brink of fiscal distress. And while we do not purport to enlighten the experts, we do anticipate that this paper can highlight the opportunity before us.

That opportunity resides in calling on government to eliminate national debt, controlling expenses with a view to investment and renewal, and prescribing tax revenue models which are most efficient over those which tax capital investment, innovation and productivity. And while intuitive, we must explicitly remind ourselves that Canada must look at the economic long term. That long term view looks to stabilization of the revenue stream, responsible and efficient program delivery and a continued diligence in drawing down the debt; both with dedicated planned surpluses and with surprise surpluses when they materialize.

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Introduction

Quite naturally, budgetary and fiscal policy finds much higher resonance amongst public policy analysts, interest groups, lobbyists, think tanks and academia than the general public. The debate however is heavily skewed towards the mix and level of taxation, and the fiscal relationship between different levels of governments. Since the challenge of chronic federal deficits has seemingly been resolved for the time being, it is not unusual for the budgetary balance (i.e. surplus) to fade as the focus of attention. Time will reveal if that holds true as the pendulum of budgetary balance slows or regresses as some are already predicting. Over recent years though, we have witnessed how the surplus does attract attention when financial results or new policy initiatives are announced. Interestingly, the debate has been directed not so much at the surplus itself, but rather at the different options in spending it. Reducing taxes and/or increasing spending have so far been the two preferred alternatives.

Over recent years, the policy debate has been directed not so much at the surplus itself, but rather at the different options in spending it

There has been, for some time, a steady call for tax cuts. Research findings suggest that Canada's tax rates (statutory, effective and marginal) are high and not internationally competitive, while the current tax system is also seen as impeding investment and innovation. Already introduced tax cuts have been skewed towards reducing 'good' taxes, such as the GST, while leaving economically ineffective tax effects almost unchanged. And those measures tend to accentuate that lower income Canadians pay relatively modest taxes, particularly in the form of income tax, and resultantly benefit little from tax cuts in absolute terms.

Alternatively, the widely debated issues of declining quality of health care, deteriorating state of the public infrastructure, and importance of human capital in the knowledge economy may suggest that surpluses are better directed towards increasing government spending and transfers to the provinces to pursue targeted programs.

Another popular option for using the surplus lies in repaying the national debt which may ease the burden of paying debt charges and free future resources. As we have learned from a number of oil-producing countries, approaches can be adopted to channel budget surpluses into the build up of a strategic fund. The borrow-and-invest strategy which is often suggested to households may also be beneficial for the economy. This, for instance, may allow government to focus on investing the surplus in innovation and technology, or other return-generating areas.

It should be noted however that the issues identified above rightfully seem to be part of a general public policy exchange on the ways to improve our economy, ensure a stronger growth, increase employment prospects, international competitiveness, higher return on investment and overall improvement in living standards. A similar discussion could take place even under a balanced (i.e. zero deficit / zero surplus) budget. The major difference would be in shifting the focus from "how to spend the surplus" to "how to spend the budget revenue". Intuitively at least, it is worth asking the question of whether the constantly reappearing federal budget surpluses are desirable in the first place?

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One might argue that with the current conditions of a sharp slowdown in the U.S. economy, ongoing dislocations in global financial markets and the overall weakening growth in the global economy, the question of having federal surpluses may simply be irrelevant. A conclusive rebuttal to this view may not be available before the fall of 2009 when the government closes its books for the 2008-09 fiscal year. Importantly however, Canada has shown over recent years a strong resilience to economic shocks that have shaken the world. Neither the late 1990s crisis on the Asian financial markets, nor the collapse of the high-tech bubble in the early 2000s extinguished the reoccurrence of federal surpluses.

That said, we believe that the question regarding the desirability of federal surpluses remains current. As such, this paper seeks to impart essence to the debate while stimulating reflection of how Canadian expectations might best be forged. In the following text, we begin our discussion by presenting a brief overview of the federal surplus and an understanding of the different surplus components. Building on that, we then examine negative implications associated with federal surpluses and the main causes leading to continued reappearance of those budgetary surpluses. Finally, we conclude by highlighting the more salient aspects of our findings and offer a practical recommendation to the surprise surplus conundrum.

Importantly also, we should recognize that surpluses; particularly the surprise element, should not be taken as a given. Although we have received positive news for some eleven years, we must acknowledge that this will not always be the case. Realistically, governments seek to achieve balance but there are social and economic factors that are both outside of the government's control and difficult to predict. That said, there may and will be, years of deficit and we shouldn't simply plan on continuously having surprise surpluses to count on. Many would agree therefore, that this is all the more reason to receive and to use surprise surpluses perceptively.

Executive Summary

1

In the spring 2008, the Certified General Accountants of Canada set out to investigate current thinking around the surprise components of federal budget surpluses. While constantly reappearing federal surpluses have become a part of the Canada's fiscal identity and the national pride, a closer investigation reveals a number of disconcerting trends. These trends lead us to question the desirability of reoccurring surprise surpluses and whether or not there are true benefits associated with them. While this paper focuses on recent surpluses, we should note also that at time of writing, certain signals are hinting at a deficit scenario within the next couple of years.

While the tides may be changing, the recent history of Canada's federal budgetary balance is truly remarkable. After more than 25 years of chronic, large-size budget deficits, the federal government has reported a string of 11 consecutive surpluses. None of the G7 countries can boast a similar record; however, consecutive budget surpluses are not a unique phenomenon among other OECD countries. Between 1992 and 2006, federal and total governments of 13 other OECD countries reported consecutive budget surpluses.

In the Canadian context, the federal surplus often has two components. The planned component is integrated into budget projections, whilst the surprise component appears when the actual budgetary balance exceeds the planned surplus. The federal government recorded 10 surprise surpluses which amounted to a total of $85 billion over 11 surplus years.

The federal government has recognized that surprise surpluses erode the credibility of the budget process and limit the scope for parliamentarians to debate the uses of surpluses. Our analysis suggests that the following elements may also be added to the list of concerns created by the reoccurring surprise surpluses:

- ***Pressure to spend***
  The regular appearance of surprise surpluses strengthens the impression that Canadians are over-taxed. The facts though, show that Canada may be characterized as a low-intermediate tax country, with decreasing size of the federal government and declining effective tax rates for both individuals and business. As such, some attention has been redirected from the level of taxation to the mix and structure of taxation conduits. Over the surplus years for example, federal tax revenues have been increasingly relying on

income taxes which are associated with high levels of economic distortion. Conversely, the role of more economically effective consumption and payroll taxes has been declining and is projected to follow this trend in the future.

Another impression associated with surprise surpluses is that the government has spare fiscal capacity to spend on various priorities. It is accurate to concede that the mid-1990s witnessed a general shift in the views of the role of social policy resulting in certain adjustments to government spending. Accompanied by drastic cuts in federal spending targeted at taming the deficit, the government, has since not had to exercise such intense fiscal restraint. In fact, government program spending adjusted for inflation and population growth has increased by nearly 30% since that time and was higher, on a per capita basis, in 2007-08 than any other year in the past 24 years.

- ***Pro-cyclical fiscal policy***
  The federal fiscal policy bears some pro-cyclical features. During the fairly strong economic growth experienced over the surplus years, federal government program spending, as a percentage of gross domestic product (GDP) has gone up, while a reverse trend can be observed for federal tax revenues. Moreover, a number of tax cut measures have been implemented during a time when the economy was already operating above its production capacity; whereas, the substantial downward revisions of the economic projections for 2008 and 2009 have not translated into noticeable adjustments to budgetary revenues and spending projections.

- ***Year-end program spending hikes***
  Traditionally, a significant amount of spending has occurred in March when year-end resources could reasonably be anticipated. During surplus years, federal program spending tends to increase not only in March but throughout the entire last third of the fiscal year. This makes it tempting to assume that the availability of excessive funds such as those associated with a surprise surplus affect the vigilance of maintaining a steady level of budgetary and essential spending. In the absence of these year-end spending hikes, these funds could have remained part of the surprise surpluses and concomitantly been directed towards paying the national debt; contributing some $30 billion more to that aim.

Knowing the negative consequences associated with surprise surpluses, it may be useful to identify their causes. Simple logic suggests that the surprise component of the surplus can only be caused by inaccuracy of budgetary projections. During the surplus years, the forecasting inaccuracy has been considered high; however, no particular tendency could be observed towards either increasing, or decreasing, or stabilizing the magnitude of inaccuracy.

The actual level of the forecasting inaccuracy is masked by in-year adjustments to policy initiatives. Our estimates reveal that the cumulative level of surprise surpluses could have been at least $50 billion higher than reported had in-year policy measures not been introduced. Moreover, the one year (i.e. 2004-05) when the federal government did not report a surprise surplus would also have revealed a surprise surplus if an in-year initiative had not been dispatched.

Taken individually and collectively, three factors are believed to nourish the inaccuracy of budgetary projections: strong economic growth, simple arithmetic and a no-deficit rule. A closer look at these factors leads to a conclusion that the no-deficit determination of the government may be the most influential among them.

There is no straightforward relationship between stronger than expected economic growth and surprise surpluses. For instance, a lower than expected economic growth in 2003-04 was accompanied by a substantial surprise surplus, whereas relatively accurate economic projections in 2006-07 also went in a tandem with an above average surprise surplus. Similarly, the growth rate of the main economic indicators affecting budgetary revenues (e.g. gross domestic product, household income and consumption) was not much better during the surplus years compared to deficit ones.

And the fact that a budgetary balance is just a mathematical difference between revenues and expenditures renders it a valid measure for all countries. However, the analysis conducted by the International Monetary Fund concluded that Canada's forecasting seems to be more inaccurate than in other countries even though Canada has a very strong institutional basis supporting the budgeting process.

As for the no-deficit rule, some critics suggest that the federal government no longer aims at avoiding deficit with the same explicit prudence within the budget forecasting cycle. However, there are still certain incentives for the government to strive for achieving surprise surpluses and their presence over the past two years is sign of that. In April 2008, the Federal Finance Minister reassured the Canadian people that due diligence and protection of the public were at the top of the Conservative agenda and that a balanced budget was consequently important. In short, all federal parties are calling for financial prudence with the prospect of an election; but as described above, there is little accord between how each would pursue that attribute. But more importantly, we need recognize that the federal government uses federal surpluses to pay down public debt. The commitment to eliminate total government's net debt in less than a generation seems to be benefiting directly from the surprise surpluses and warrants strategic consideration.

It may be however that planned surpluses can pay off the debt as effectively as surprise surpluses but that Canadians simply don't receive the news as positively for fear of being deliberately over-taxed. The fact of the matter though is that the surprise surplus methodology has simply become problematic of late as Canadian appetite for tax cuts has swelled.

All considered, one can't help wonder if surprise surpluses have become strategy. As a tactic, it does have appeal and creates, over time, a norm which permits accelerated debt retirement.

We all have to wonder if surprise surpluses (and deficits) are truly economic irregularities. And if they really represent new found money, perhaps we need to support the notion of becoming debt-free.

Budgetary Surplus – An Overview

2

For some young adults, experience with federal deficits may be limited to reference of archive documents, whereas for most Canadians the deficit years are part of a remote past. Many would agree that federal budget surpluses have become a norm of our lives and that their more than a decade history has rendered Canadians fairly aware of the presence and nature of the phenomenon. And yet, we reckon it is useful to begin our discussion by setting up a uniform stage for our further considerations. For that reason, we begin our discussion with a brief overview of Canada's history with budgetary balance and how we fair in an international context. For sake of comprehension, we also deliberate on different approaches to defining the very notion of a federal surplus.

2.1. A Historic Glance at Canada's Federal Budgetary Balance

The budgetary balance shows the gap between revenues and expenditures as they are earned or incurred over the course of a given period of time. The recent history of Canada's federal budgetary balance is truly remarkable. After more than 25 years of chronic, large-size budget deficits, the federal government has consistently closed its books in the black since 1997 with significant budget surplus.

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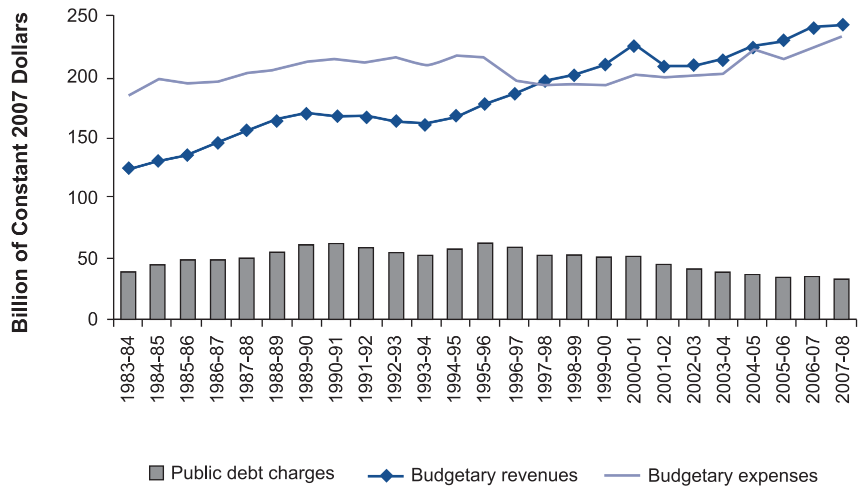
Interest rate growth outpacing Canada's economy and structural economic weaknesses such as decline in productivity growth and stagnation of household disposable income are often cited as the main causes of the budget distress in the 1970s, 1980s and through the early 1990s. In those years, budget revenues failed to match government expenditures even despite the rising tax rates.[1] By the mid 1990s, Canada was caught in a vicious fiscal cycle where high deficits were pushing up interest rates which, in turn, were depressing economic activity which led to an exacerbated fiscal situation. The interest charges paid on the public debt had become the largest single component of the government's expenses and the increasing public debt was largely driven by the rising debt servicing burden (Figure 1).

1 Department of Finance Canada (1994). *A New Framework for Economic Policy.*

Figure 1 – Dynamic of Federal Budgetary Components



Note: The choice of the timeline is based on the availability of data presented on full accrual accounting basis

Source: Fiscal Reference Table 2007, The Budget Plan 2008, Department of Finance Canada; CANSIM Table 326-0020, CGA-Canada computation

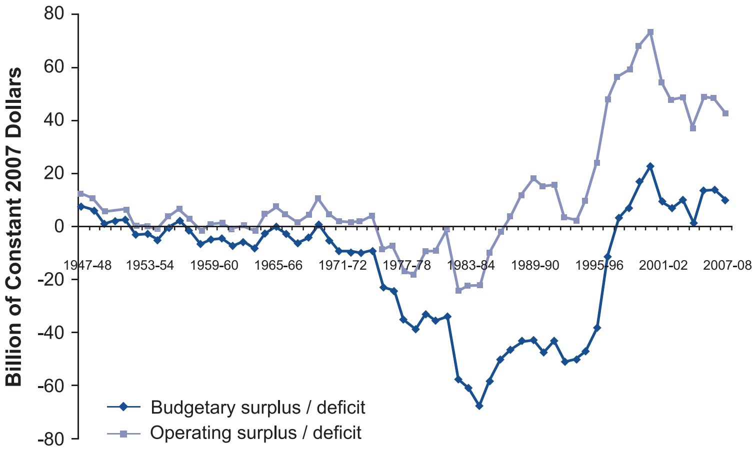
Changes in the general approach to public management and favourable economic conditions resulted in a seemingly magic disappearance of the federal deficit

The 1980s and the early 1990s experienced certain attempts to improve the budgetary balance. The operating balance – the excess of revenues over program spending – became positive during the 1987-88 fiscal year; a decade prior to achieving budgetary surplus (Figure 2). Yet, the positive margin of the operating balance achieved at that time was not sufficient to offset the mounting debt service charges and was unable to withstand the negative consequences of global recession of the early 1990s.

Balancing the federal budget became a number one priority of Budget 1995. It aimed to "put the fiscal house in order" by striving for a smaller but smarter government – a new vision of the government's role in the economy.[2] This tightening of budgetary spending was also linked to a much broader change in the general approach to public management. One which was focused on clarification of federal roles and responsibilities, an improved honing of resources for high priority issues, using modern practices to service delivery, and more affordable government.[3] These measures and favourable economic conditions resulted in a seemingly magic disappearance of the federal deficit and eleven consecutive years of federal budget surplus.

2 Martin, P. (1995). *Budget Speech.*
3 Pal, L.A. (2006). *Beyond Policy Analysis: Public Issue Management in Turbulent Times*, 3rd ed. Toronto: Thomson Nelson, p. 206.

Figure 2 – Federal Budgetary Balance – Historic Perspective



Source: Fiscal Reference Tables 2001 and 2007, The Budget Plan 2008, Department of Finance Canada; CANSIM Table 326-0020; CGA-Canada computation. See Appendix I regarding the data accuracy.

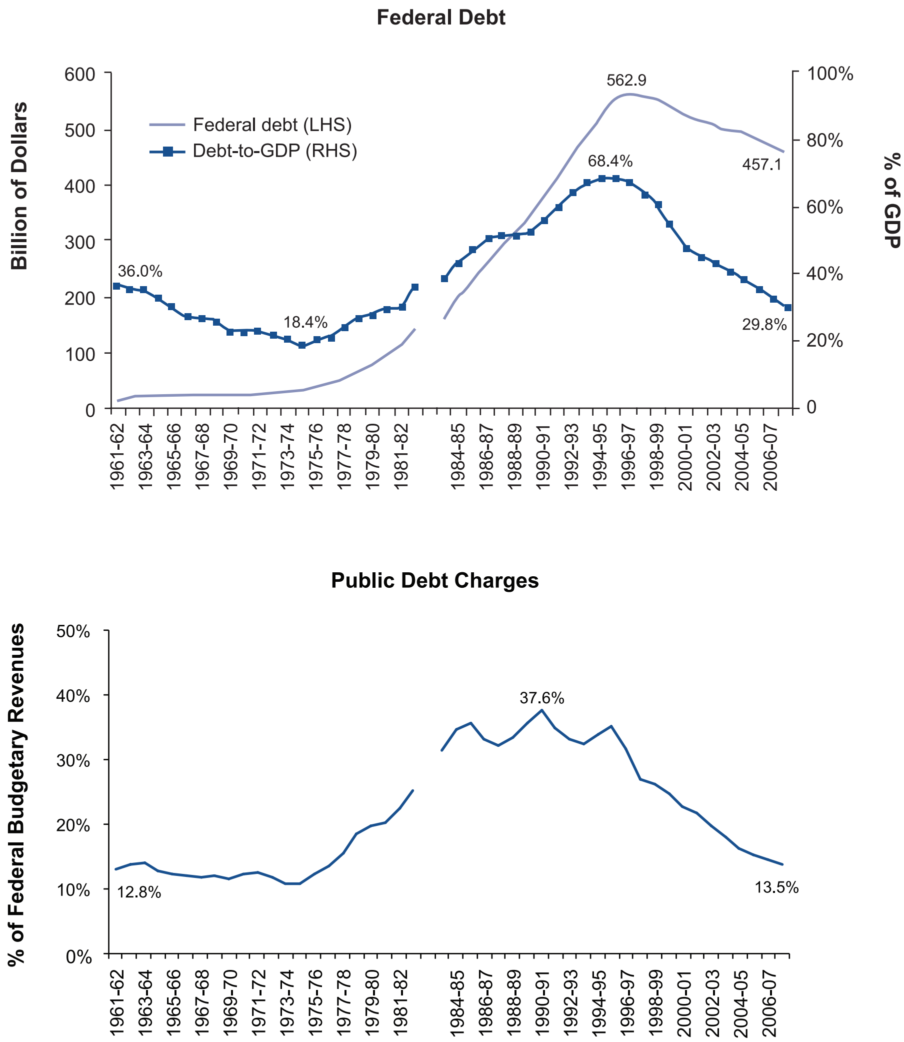
The aspiration of restoring the nation's finances to health was focused on moving away from temporary fiscal remissions to a consistent improvement of the federal fiscal position. As such, the goal of overcoming the deficit was further supplemented by a debt reduction strategy first introduced in The Debt Repayment Plan in 1998. Initially, the strategy was focused on reducing the absolute amount of the debt; however starting with Budget 2004, the target was shifted towards achieving a certain level of debt-to-GDP ratio. Since its peak in 1996-97, the federal public debt has been reduced by some $106 billion reaching the mark of $457.1 billion at the end of 2007-08 fiscal year. As a result, the debt-to-GDP ratio was reduced by more than twice compared to its highest level in 1995-96 (top chart of Figure 3). The public debt charges have declined accordingly leaving higher proportion of the federal revenues to be spent on purposes other than servicing the debt. While in the early 1990s, more than one third of the budgetary revenues had to be committed to servicing the federal debt, by the end of 2007-08, only 13.5% of revenues had to be dedicated to paying interest on the debt (bottom chart of Figure 3).

Extending the international comparison group from G7 to countries that are members of the OECD may change our view of the uniqueness of the Canadian federal surplus

2.2. International Perspective

It is quite frequently and proudly reiterated that Canada is the only G7 country that is currently in surplus, has a strong historic record of consecutive surpluses, and is expected to be in surplus in the near future. Although true, comparison with only G7 countries narrows significantly the range of countries that are similar to Canada in terms of size, trade openness and technologic development. Extending the comparison group to countries that are members of the OECD may change our view of the uniqueness of the Canadian federal surplus.

Figure 3 – Evolution of the Federal Government Debt



Note: The break in series between 1982-83 and 1983-84 fiscal years marks the shift from modified accrual to full accrual accounting framework

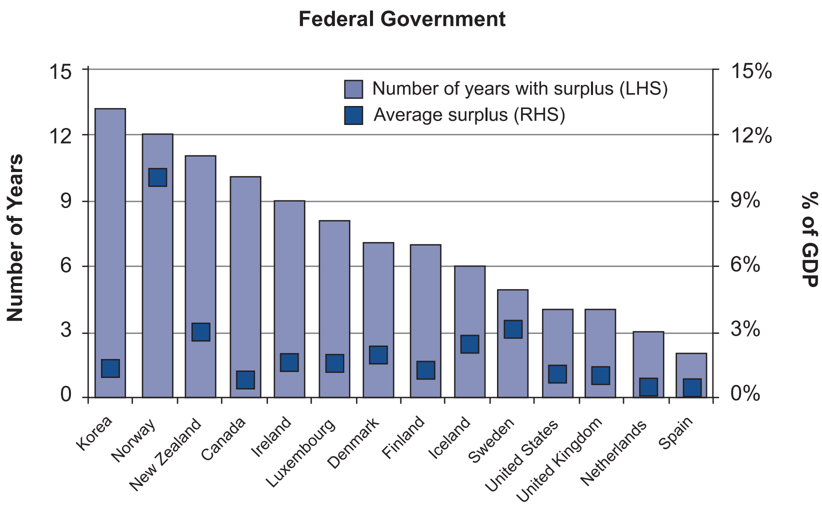
Source: Fiscal Reference Table 2007, The Budget Plan 2008, Department of Finance Canada; CANSIM Table 380-0017, CGA-Canada computation

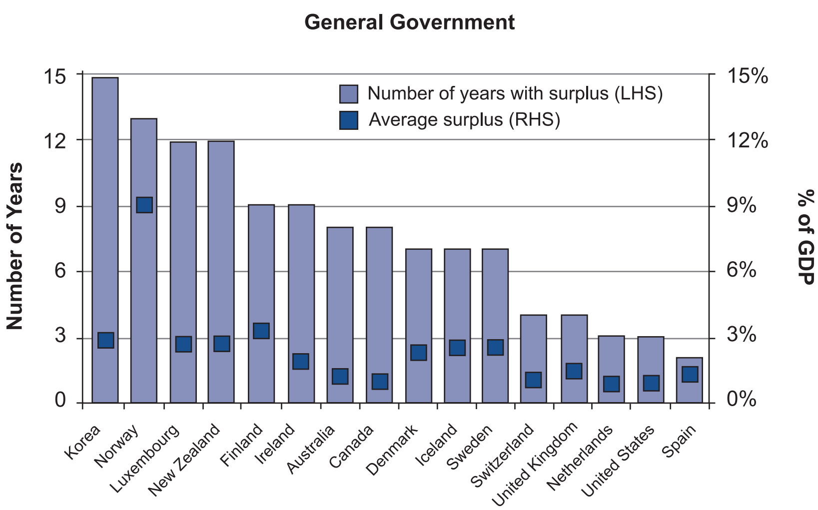
In the past fifteen years, 14 OECD countries reported federal surplus during two or more consecutive years

Federal governments[4] of nine OECD countries reported budgetary surplus in 2006. This constituted one third of all OECD countries for which information on the federal government is available. Moreover, in the past fifteen years, 14 OECD countries reported federal surplus during two or more consecutive years (top bar chart of Figure 4). With only two exceptions, the average level of surplus in those countries was higher than that in Canada.

4 OECD statistics is reported for four subsectors of the general government: (i) central government, (ii) state government, (iii) local government, and (iv) social security funds. Canada's federal government is the Canadian equivalent of the central government used in the OECD classification. To maintain the consistency with the rest of the report, the international comparison will be discussed using the term "federal government" rather than "central government" commonly used by the OECD.

Figure 4 – International Incidents of Budget Surpluses, 1992-2006





Source: Top bar chart: National Accounts of OECD Countries – Volume IV – General Government Accounts. Bottom bar chart: OECD Statistics Portal (accessed on February 22, 2008). CGA-Canada computation.

Certain differences may exist in the financial responsibilities among different levels of government. Due to this, the international comparison is often based not so much on analysing the financial performance of one of the levels of the government (e.g. federal government), but on considering the so-called "general government" encompassing the variety of public sectors in the economy. For Canada, general government includes the federal, provincial-territorial and local government sectors, as well as the Canada Pension Plan and the Quebec Pension Plan.

For some of the OECD countries, the surplus was persisting for more than a decade

General governments of 16 OECD countries registered surpluses in two or more consecutive years between 1992 and 2006 (bottom bar chart of Figure 4). For some of them (e.g. Korea, Norway, Luxembourg and New Zealand), the surplus was persisting for more than a decade. The performance of Canada's general government was somewhat less remarkable than that of the federal government with only 8 years of surplus to boast of. Overall, the 1990s where the years when a broad range of countries underwent various degrees of fiscal consolidation, and about 18 industrialized countries balanced their budgets during approximately the same time as Canada.[5]

The cavities of the international comparison lie not only within the range of countries used as a benchmark, but also within the fact that the accounting framework used for the international comparison is different from the one in which budgetary numbers are reported to Canadian Parliament and thus most known to the Canadian general public.

Budget documents prepared for Parliament are based on the Public Accounts accounting framework – an accounting standard set by Canadian regulatory bodies. This framework focuses on the *financial* activities of the government and provides a snapshot of the government's finances at a given point in time.

Its international counterpart, in turn, is usually based on the system of the National Accounts which allows mitigating the differences in the accounting frameworks used in different countries. Unlike the Public Accounts, the National Accounts are focused on *economic* activities of the government and based on the international accounting conventions set out by the United Nations. The National Accounts look at the production and income side of government operations and reflects a much broader definition of the government than do the Public Accounts.

Budget deficits calculated on the National Accounts basis are usually lower than those computed using the Public Accounts basis as the latter does not include the net amount of the federal government's employee's pension funds.[6] In some cases, this may mean that a budget position reported as a surplus based on the country's internal reporting system is reported as a deficit based on the international accounting conventions. Identifying specific examples of such cases would go beyond the scope of this study; however, this provides a useful reminder that Canada's international lead-runner position in terms of budgetary balance is a subjective matter.

5 Stanford, J. (2003). *Paul Martin, the Deficit, and the Debt: Taking Another Look*, Canadian Centre for Policy Alternatives, Alternative Federal Budget 2004, Technical Paper #1.
6 Department of Finance Canada (1996). *The Economic and Fiscal Update*.

And although the international perspective provides an interesting peek into other countries' fiscal affairs, our interests lie first and foremost with Canada. Consequently, the balance of our discussion will be focused on the budgetary surplus of Canada's federal government.

2.3. Planned vs. Surprise Surpluses

Over the past decade, the term "budget surplus" has been routinely used in the media, analytical publications and government documents. The Department of Finance Canada defines surplus as "the amount by which government revenue exceeds budgetary spending in any given year",[7] while most publications coming from other sources than the government do not provide a specific definition and use the term "surplus" as a self-defined concept. While we agree with the general definition used by the Department of Finance Canada, the current structure of the federal budget implies certain duality of the surplus. As you will have noted for the purpose of this report, the two components of the federal surplus are considered to be the planned surplus and the surprise surplus.

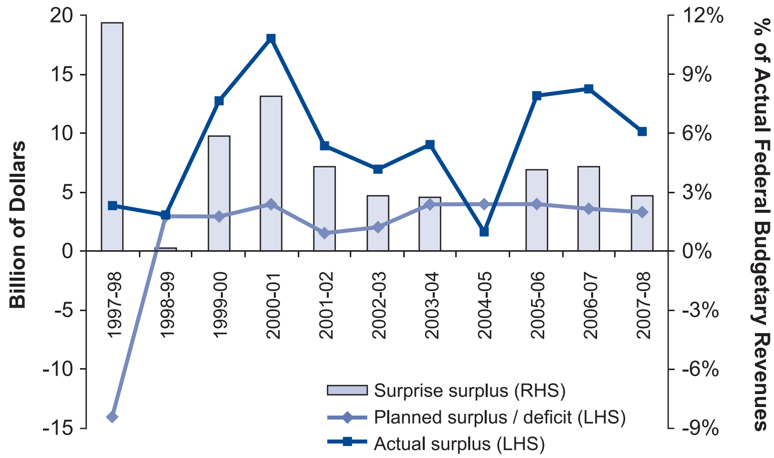
The *planned federal surplus* is integrated in the projections presented in the federal budget each year and can be calculated as the difference between budgetary revenues and the sum of program spending and public debt charges. Once the first surplus was reported in 1997, successive federal budgets have continued to include planned surplus; however the language used to define them has changed several times over the years. In the late 1990s, planned surplus was called "underlying balance"; in the early 2000s it was renamed to "underlying budgetary surplus"; and, starting in 2006 it became a combination of "planned debt reduction" and "remaining surplus".

The federal government recorded 10 surprise surpluses over the past 11 years. They summed to a noticeable $85 billion at the end of 2007-08.

Surprise federal surplus occurs when the actual budgetary balance exceeds the planned surplus. The federal government recorded 10 surprise surpluses over the past 11 years. They averaged $8.6 billion a year and summed to a noticeable $85 billion at the end of 2007-08 fiscal year. In relative terms, the level of surprise surpluses is also remarkable: it reached as high as 11.6% of actual budgetary revenues in 1997-98 and averaged at 4.6% during the surplus years (Figure 5).

7 Glossary, Department of Finance Canada, available at: http://www.fin.gc.ca/gloss/gloss-s_e.html#Surplus, accessed on April 12, 2008.

Figure 5 – Planned vs. Surprise Federal Surpluses



Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

The timeframe is also important when speaking about federal budgetary surpluses. Federal surpluses may be examined by looking into the past years for which the levels of projected and actual surpluses are already known and their use has already taken place. A forward looking approach may also be applied as the budget documents and fiscal updates include projections of the underlying surplus for several years ahead. These projections are usually presented in two forms. First is a status quo fiscal outlook which shows expected budgetary components given the current economic conditions. Second is a fiscal outlook that includes policy measures introduced since the last budget or fiscal update. Past experience shows that new policy measures often "consume" most of the surpluses present in the status quo projections. In that way, the surpluses may be considered as "spent" on the new policy initiatives and thus transformed into budgetary revenues and/or expenses. For the purpose of this paper, we focus our discussion on the federal surpluses which have already occurred as only those may be truly and surely referred to, or relied upon, as budgetary surpluses.

The purpose of the planned component of the surplus has been fairly straightforward; however, changing over time

The purpose of the planned component of the surplus has been fairly straightforward; however, changing over time. Through the 1997-2005 periods, planned surpluses were used to form the Contingency Reserve and the Economic Prudence reserve (the latter was first introduced in Budget 2000). The purpose of these reserves was to protect the fiscal targets against unforeseen developments and economic uncertainty. If the contingency reserve was ultimately excessive, it was redirected to debt retirement while the economic prudence was directed to fund government priorities. Commencing in Budget

2006, planned surpluses are principally assigned towards planned debt reduction; however, the possible use of planned surplus in excess of the portion assigned towards debt repayment (the so-called "remaining surplus") is ambiguous.

The possible use of surprise surpluses has been less obvious. The Unanticipated Surpluses Act introduced into the Parliament in 2005 sought to bring some clarity to the issue but has not been passed into a law. Budget 2006 suggested examining the possibility of allocating a portion of surplus to the Canada Pension Plan and Quebec Pension Plan. The wording used in Budget 2007 was more specific and targeted to use surprise surpluses for debt reduction; however, this wording is not repeated in Budget 2008.

The possible use of surprise surpluses has been less obvious

One should keep in mind, though, that the level of surplus may be affected not only by the difference between budgetary revenues and expenditures but also by the accounting rules used to prepare government financial statements. The 1997-98 fiscal year provides a good example. The change in methods of accounting for assistance to international financial institutions introduced in 1997 reduced the 1997-98 surplus by $1.8 billion, whereas changes in the method used to calculate interest costs on obligations for public sector pensions affected the 1997-98 surplus in the opposite direction increasing it by $2.5 billion.[8] In so doing, under the initial accounting rules, the federal surplus would have been reported as $2.4 billion, while accounting changes introduced in 1997 pushed the dollar amount of the surplus up to $3.1 billion.

Accounting and reporting changes introduced during the surplus years also created certain challenges for composing a historic data set reflecting the dollar amounts of the budgetary components. Appendix I provides more details on the technical challenges encountered when comparing historic data presented in the government financial statements.

As seen from the discussion above, Canada has achieved a truly remarkable turnaround in its federal fiscal balance. Fully appreciative of this achievement, it is important to remember that Canada's surplus is not a unique phenomenon amongst industrialized countries; and it is not judicious to interpret it as an unequivocal indicator of Canada's performance relative to the international environment. Different countries apply different approaches and set different goals for their fiscal policies. In this regard, we believe that a critical review, rather than a soothing satisfaction is due regarding the federal surpluses, particularly the continuously reappearing surprise components of the federal surplus. The pages that follow intend to do that.

8 Receiver General for Canada (1997). *Public Accounts of Canada 1997, Volume I – Summary Report and Financial Statements*.

Negative Implications of the Federal Surplus

3

Year after year, a large number of industrialized and developing countries struggle to reduce their deficits and to bring their public finances in line. One may confidently assume that many of those countries would wish to have at least a fraction of Canada's success in balancing the federal budget and achieving consecutive surpluses. And yet, we dare to say that there are negative implications of budget surpluses, particularly when they are not explicitly planned.

As the federal government itself admitted in 2006, the continued reappearance of larger than expected surpluses has eroded the credibility of the budget process and limited the scope for parliamentarians to debate the uses of funds.[9] Such other concerns as pressure to spend the excessive fiscal room, pro-cyclical nature of fiscal policy and eroded vigilance of maintaining a steady level of spending may also be added to the list of negative implications triggered by surprise surpluses. The paragraphs that follow consider these implications in more detail.

The continued reappearance of larger than expected surpluses has eroded the credibility of the budget process and limited the scope for parliamentarians to debate the uses of funds

3.1. Pressure to Spend

The regular appearance of surprise surpluses creates an impression that excessive fiscal capacity exists and serves to ignite a debate on how to spend those funds. The major clash happens when we attempt to reconcile opposing views between those who believe that Canadians are over-taxed and thus that a major tax reduction is due, and those who believe that the spending role of the government has been eroded and thus higher spending on new or expanded federal programs should be sanctioned. And even if we accept these arguments at face value, there is still the question of whether the impressions of over-taxation and under-spending are as accurate as they seem to be.

3.1.1. Over-taxation

At least perceptually, reoccurring budget surpluses may resemble a form of over-taxation. Indeed, it is quite natural to assume that if the government collects more money than it plans to spend, the revenue collection tools (i.e. taxes) are set at a level higher than necessary. The persistence with which calls for lower taxes are made also serves as an indicator of our perception of being over-taxed. For instance, a number of prominent interest groups still

9 Department of Finance Canada (2006). *The Budget Plan*, p. 53.

expressed their disappointment with the absence of tax reduction measures offered by Budget 2008[10] although this was only few months after the government announced a fairly substantial tax cut package in October 2007.

Over-taxation is a complex notion to judge and depends on the unit of analysis selected to analyse the economy as a whole, or particular economic agents such as individuals and businesses. It may also differ depending on whether we look at the overall tax burden imposed on the economic agent or the burden levied by a particular tax regime. Canada's multiple levels of taxation – federal, provincial and municipal – further add to the complexity of the issue. Choosing the benchmark for assessing over-taxation is equally intricate; for example, are we over-taxed compared to the level of taxes of some thirty years ago, or compared to today's situation in other countries, or relative to the services Canadians can expect to enjoy?

Canada may be ranked as a low-intermediate tax country based upon average annual tax revenue-to-GDP ratio

Acknowledging these complexities, we focus our discussions on only two of the aspects of taxation which have a direct relevance to the fiscal policy and surprise surpluses: (i) proportion of revenue collected through taxes, and (ii) mix of taxes used to collect revenue.

Level of tax revenue

The level of budgetary revenue collected through taxes determines, to a great extend, the size of the government and the value of goods and services that a country chooses to provide on a collective basis. Considering the notion of over-taxation through a prism of the government's size leads to a broader political economy debate regarding the values citizens attach to those public goods. Although contributing to this type of a debate would go beyond the scope of this report, several facts are deemed to be most interesting.

First, a recent study conducted by the Canadian Centre for Policy Alternatives (CCPA) ranked 21 industrialized countries in terms of the level of their taxes.[11] Based upon the commonly relied on average annual tax revenue-to-GDP ratio, the countries were assigned one of four categorizations: low-tax, low-intermediate tax, high-intermediate tax and high-tax countries. Surprising to some, Canada was ranked as a low-intermediate tax country and was only eight countries from being the one having the smallest tax burden relying on the methodology employed by the CCPA. While we note that other models of evaluation might dampen this outcome, particularly those which isolate the

10 See, for instance, Canadian Chamber of Commerce (2008), *Budget Does Not Go Far Enough on Tax Relief*, News Release, February 26, 2008; Canadian Federation of Independent Business (2008), *National Legislative Action – Budget Reaction*; Canadian Taxpayers Federation (2008), *A New Tax Savings Plan & Modest Spending Growth*, News Release, February 26, 2008.

11 Brooks, N. and Hwong, T. (2006). *The Social Benefits and Economic Costs of Taxation: A Comparison of High- and Low-Tax Countries*, Canadian Centre for Policy Alternatives. The following countries were considered by the study: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States.

alternate conduits of taxation or their basis of computation, the principle point is that 'the whole' of Canada should not typically be viewed as a peculiarly high tax nation.

Second, the size of Canada's federal government has been decreasing over the surplus years. While tax revenues of the federal government accounted for 16.8% of GDP in 1997-08 fiscal year, this proportion went down to 14.5% in 2007-08 and is projected to reach as low as 13.9% in 2009-10.[12]

Third, effective tax rates[13] of households and businesses have been declining over the past years as well. As seen from Figure 6, the personal income tax burden – the largest and most obvious tax burden borne by Canadians, decreased from 17.9% in 1999 to 16.5% in 2005. The decreasing effective federal tax rate made its own contribution to this. The tax burden levied on businesses showed a declining trend as well. The average effective federal tax rate levied on all industry went down to 14.6% in 2006 from as high as 17.7% in 2000.

Type of taxes used

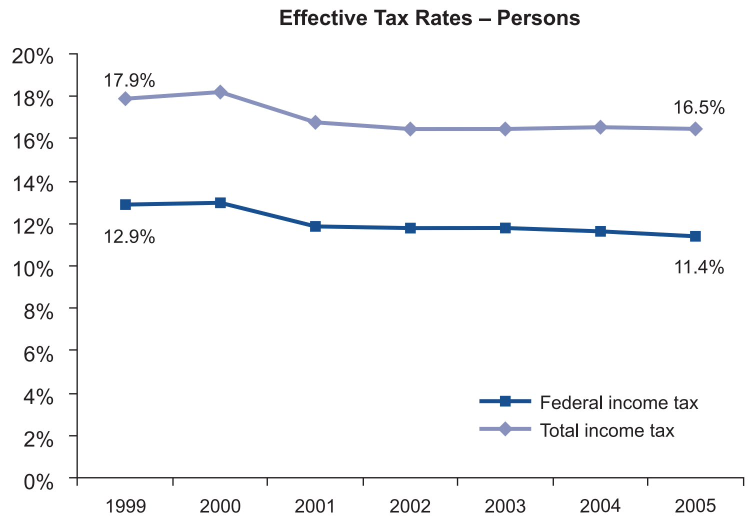
The type of tax used for collecting tax revenues affects greatly the degree of distortion and the level of the redistributive effect the government brings to the economy. For instance, capital-based taxes decrease incentives to save and invest, whereas consumption taxes are known to reduce incentives to work. Although Canada has made some progress in improving its tax system, Canada's mix of taxes remains heavily criticized.

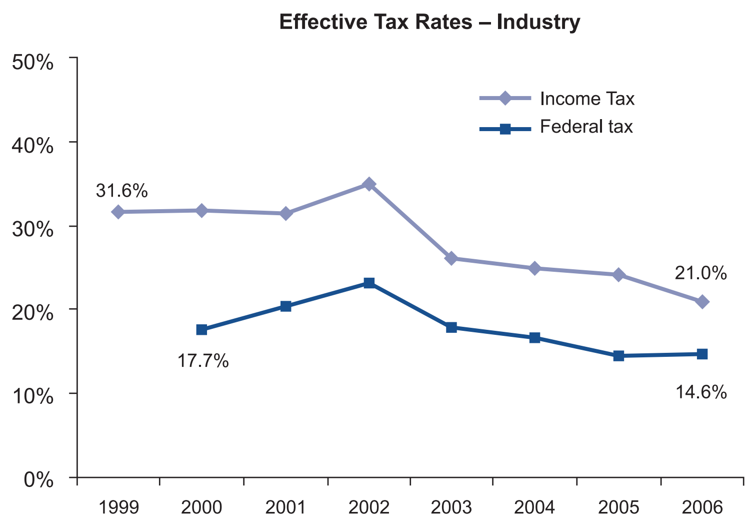
The size of Canada's federal government has been decreasing over the surplus years. Effective tax rates of households and businesses have been declining as well.

As was discussed in a recent CGA-Canada brief,[14] the existing body of research identifies and rationalizes a distinction between "good taxes" and "bad taxes". The general rule suggests that good taxes are associated with relatively low costs to society and high economic efficiency in allocating human and capital resources. A number of economic models testing empirical data for different countries came to similar conclusions regarding the economic efficiency of different types of taxes. The results of these models produce the following ranking of taxes in terms of their economic efficiency (from higher to lower efficiency): (1) consumption taxes, (2) payroll taxes, (3) personal income taxes, (4) corporate income taxes, (5) sales taxes on capital goods, and (6) personal capital income taxes.[15]

12 Based on Fiscal Reference Tables 2007, The Budget Plan 2008, Department of Finance Canada.
13 The effective tax rate for persons is defined as a ratio of total income tax paid to total income assessed in all tax returns. The effective tax rate for industry is defined as a ratio of total amount of taxes paid by all industries to total profit before income tax.
14 CGA-Canada (2008). *Issue in Focus – Is Cutting the GST the Best Approach?* Available at www.cga.org/canada
15 Baylor, M. (2005). *Ranking Tax Distortions in Dynamic General Equilibrium Models: A Survey,* Department of Finance Canada, Working Paper 2005-06.

Figure 6 – Effective Tax Rates





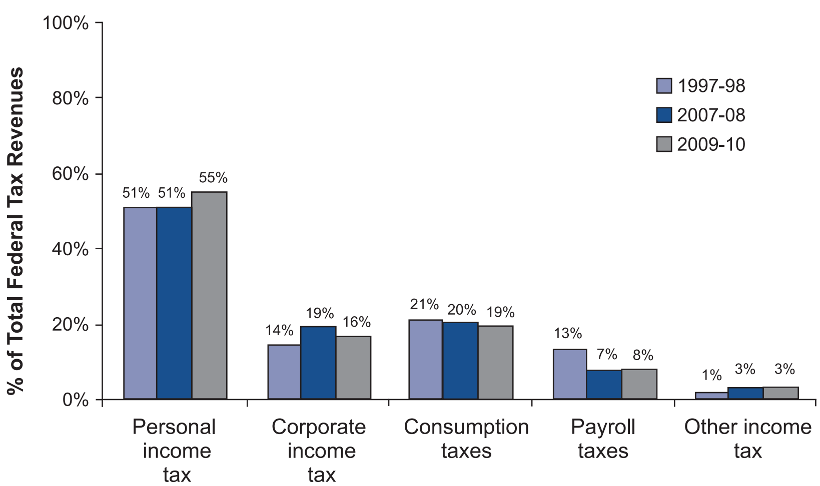
Note: The choice of the timeline in both charts is based on data availability.

Source: Top chart: Fiscal Basic Table 1, Income Statistics 2001 to 2007, Canada Revenue Agency. Bottom chart: CANSIM Table 180-0003. CGA-Canada computation.

The tax composition of the federal revenue favours greatly the fairly distortive personal income tax which accounted for half of the all taxes collected by the federal government in 2007-08 (Figure 7). More important, though, is the dynamic of the tax revenue structure overtime. Despite a number of tax reducing initiatives, the proportion of fairly distortive income taxes (both personal and corporate) has slightly increased over the surplus years, while the proportion of consumption and payroll taxes – those which are associated with high economic efficiency – decreased. Furthermore, the two-year fiscal projections presented in Budget 2008 suggest that reliance on personal income taxes will further increase while the share of consumption taxes in the federal tax revenue will continue to decline. This sharply contrasts with the general tendency observed in other OECD countries whose consumption taxes play an increasingly more important role.[16] What is more is that domestic public criticism may be on the rise for having reduced taxes; especially the goods and services tax (GST).

The tax composition of the federal revenue favours greatly the fairly distortive personal income tax which accounted for half of the all taxes collected by the federal government in 2007-08

Figure 7 – Composition of Federal Tax Revenue



Note: Consumption taxes are recognized as the sum of goods and services tax, customs import duties and other excise taxes/duties, whereas payroll taxes are recognized as employment insurance premium revenues

Source: Fiscal Reference Tables 2007, The Budget Plan 2008, Department of Finance Canada, CGA-Canada computation

Putting the facts and trends described above in the perspective of surprise federal surpluses may suggest that it is not so much the overall level of the tax burden that should be of a concern, but rather the mix of available tax avenues. A lower amount of tax revenue collected using highly distortive taxes is less likely to lead to improved living standards when compared to higher revenue collected through efficient taxes.

16 Organisation for Economic Co-operation and Development (2004). *Recent Tax Policy Trends and Reforms in OECD Countries*, OECD Tax Policy Studies No. 9.

3.1.2. Under-spending

The notion of under-spending is not as widespread as the expressed views relating to the alleged excessive tax burden; however, should not be ignored. Two noticeable shifts in public policy are worth noting when considering the issue of under-spending.

First is the representation of the general shift in the paradigm that defines the social policy. It is the shift from the social security programs designed to protect individuals from different types of economic disruptions to programs focusing on investing in developing and improving peoples' knowledge and skills that would allow individuals to cope effectively with economic transitions. However, some experts believe that the reduction in the income protection was much more abrupt than the increase in funding for education and training, leading, thus, to a decreased economic security.[17]

Government spending adjusted for inflation and population growth has been increasing over the surplus years

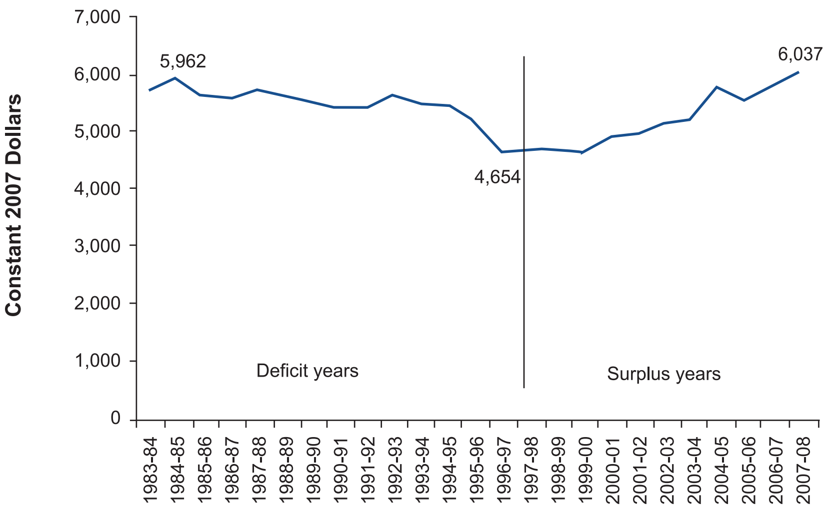
Second is the magnitude of fiscal restraint exercised to combat the budget deficit. Total program spending, which is one of the major policy instruments of the federal government, went down dramatically in the mid 1990s. It accounted for $122.2 billion in 1992-93 but decreased by some 14% in real terms by the end of 1996-97.[18] A similar trend was observed in program spending as a share of GDP. This drop was largely achieved by changes in the unemployment insurance system, cuts in health and social transfers to the provinces, and reduced compensation of public employees.

These policy shifts and constantly reappearing surprise surpluses create strong preconditions for some stakeholders to advocate for increased government spending that would rebuild to the government's spending capacity enjoyed in past decades. It should be noted, though, that government spending adjusted for inflation and population growth has been increasing over the surplus years and by 2007-08 has already surpassed its historic peak of 1983-84 (Figure 8). It grew at an average annual rate of 2.5% between 1997-98 and 2007-08 while accelerating to 4% growth in 2006-07 and 2007-08 fiscal years. One has to wonder if it is sustainable to continue with such increases; leave aside a premeditated acceleration of federal program spending.

It would be interesting to observe how the tone of advocacy for tax cuts and spending increases might behave in the absence of the surprise federal surpluses. Hardly any empirical simulation or statistical analysis may shed light on this, and answering this question would definitely be speculative. Our bet is that the calls for reform would be fewer and the concern over government's financial distress greater. But, why would that be so if the surprise surplus is not even supposed to be there in the first place?

17 Green, D.A. and Kesselman, J.R. (2006). *Dimensions of Inequality in Canada*, UBC Press, p. 418-445.
18 Based on Fiscal Reference Tables 2007 and CANSIM Table 326-0020, CGA-Canada computation.

Figure 8 – Federal Program Spending Per Capita



Note: The choice of the timeline is based on the availability of data presented on full accrual accounting basis

Source: Fiscal Reference Tables 2007, The Budget Plan 2008, Department of Finance Canada; CANSIM Tables 326-0020, 051-0005. CGA-Canada computation.

3.2. Pro-cyclical Nature of Fiscal Policy

Economic theory suggests that fiscal policy should strive to be counter-cyclical. This would mean that during the economic boom, total government spending as a share of GDP should go down, whereas government revenues as a share of GDP should go up. These fluctuations are triggered by so-called automatic stabilizers (e.g. variation in personal income tax revenues and Employment Insurance expenditures) which, in turn, are driven by the intensity of the economic activity.

Pro-cyclical fiscal policy, in turn, has the opposite characteristics: during economic booms government spending as a share of GDP goes up while tax rates go down. Pro-cyclical fiscal policy is deemed to be sub-optimal and adds to macroeconomic instability as it may require adjustments that exacerbate economic weakness during economic downturns and prevent functioning of automatic stabilizers. Pro-cyclical fiscal policy is typical for developing countries whereas industrialized countries such as OECD countries generally have counter-cyclical fiscal policy.[19]

The budgetary characteristics of the federal government bear some pro-cyclical features

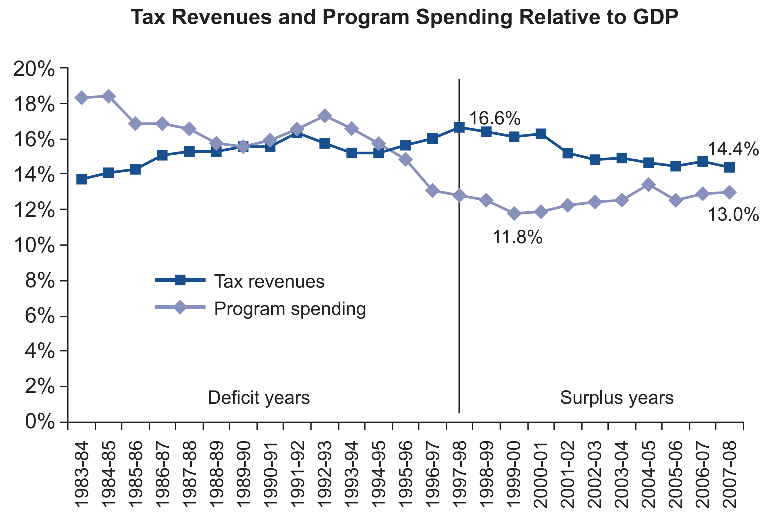
Although Canada can hardly be considered as a developing nation, the budgetary characteristics of the federal government bear some pro-cyclical features. As seen from the bottom chart of Figure 9, the Canadian economy

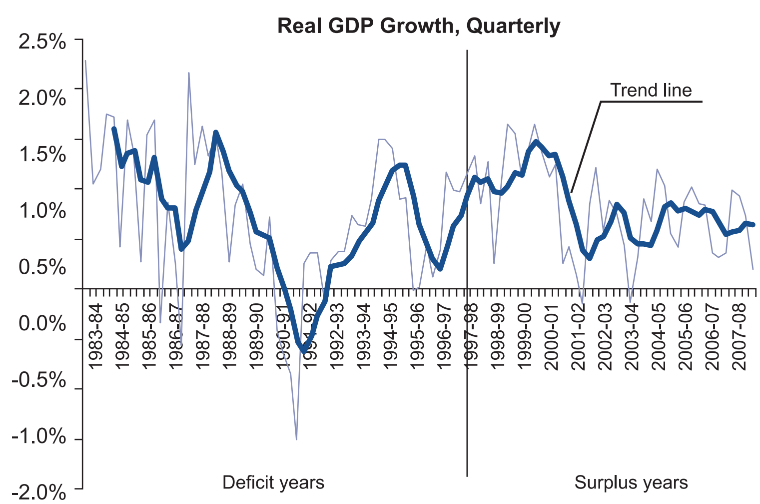
19 Alesina, A. and Tabellini, G. (2006). *Why is Fiscal Policy Often Procyclical?*, Institute for Economic Research, Harvard University, Discussion Paper no. 2090.

experienced a fairly strong economic growth over the surplus years with only few small exceptions in the early 2000s. Despite that, federal government program spending as percentage of GDP went up reaching 13% in 2007-08 from its lowest of 11.8% in 1999-00. A reverse trend was observed for federal tax revenues which may be considered as a national tax rate when measured as a proportion of GDP. Over the surplus years, revenue-to-GDP ratio declined from 16.6% in 1997-98 to 14.4% in 2007-08 (top chart of Figure 9).

Despite a fairly strong economic growth over the surplus years, federal government program spending as percentage of GDP went up while tax revenue-to-GDP ratio declined

Figure 9 – Budget Components and Business Cycle





Note: The choice of the timeline is based on the availability of data presented on full accrual accounting basis. Nominal GDP is adjusted for fiscal year time framework.

Source: Top chart: Fiscal Reference Tables 2007, Department of Finance Canada; CANSIM Table 380-0002; CGA-Canada computation. Bottom chart: CANSIM Table 380-0002.

The increasing government spending and decreasing budgetary revenues shown in Figure 9 came as an additional stimulus to the economy which was already exhibiting strong growth. For instance, the 2000 Five-Year Tax Reduction Plan was announced in the year when the economy was already operating above its full capacity[20] – an indicator that suggests a presence of an excessive demand in the economy. Similarly, the Canada's Tax Fairness Plan announced in 2006 added in that year some $14 billion to the economy operating above its full capacity.[21]

A somewhat opposite trend was observed in Budget 2008. The turbulence on the financial markets that broke out in the summer 2007 caused the economic projections to be revised down for 2008-09 and 2009-10 fiscal years. At the time of writing this paper, two downward revisions have been made since Budget 2007 – the latest budget forecast made prior to the economic slowdown. The projections were revised in the Economic Statement 2007 and then in Budget 2008. Table 1 provides a summary of the revisions.

Table 1 – Projections of Real GDP Growth, Tax Revenues and Spending

	2008			2009		
	Real GDP growth	Tax revenue-to-GDP	Program spending-to-GDP	Real GDP growth	Tax revenue-to-GDP	Program spending-to-GDP
Initial projections (Budget 2007)	2.9%	14.2%	13.2%	N/A	N/A	N/A
1st revision (Economic Statement 2007)	2.4%	13.9%	12.9%	2.7%	13.8%	12.9%
2nd revision (Budget 2008)	1.7%	13.9%	13.1%	2.4%	13.9%	13.2%

Source: The Budget Plan 2007 and 2008, Economic Statement 2007, Department of Finance Canada

As seen from Table 1, the revisions to the economic growth for 2008 and 2009 were fairly substantial. However, this translated into only minor adjustments to the expected levels of budgetary revenues and expenses. For fairness sake, it should be mentioned that the tax reduction package announced in October 2007 was a timely supportive measure for the economic downturn unfolding since summer 2007. However, it remains questionable if these measures were triggered by the anticipation of the difficult economic times or for other reasons. Among the different instruments that government can use to influence the economy, the interest rate set by the central bank is considered to be a most responsive and timely government intervention. The first policy measure taken by the Bank of Canada in response to the economic downturn was in December 2007, already after the government's announcement of the tax measures.

The increasing government spending and decreasing budgetary revenues came as an additional stimulus to the economy which was already exhibiting strong growth

20 Bank of Canada (2006). *Monetary Policy Report*, October 2006 (Chart 4)
21 Bank of Canada (2008). *Monetary Policy Report*, January 2008 (Chart 3)

3.3. Year-end Program Spending Hikes

Traditionally, a significant amount of annual spending has occurred in March.[22] However, during surplus years, federal program spending tended to increase not only in March but also throughout the entire last third of the fiscal year. This makes it tempting to hypothesize that the availability of excessive funds, such as those associated with a surprise surplus erodes vigilance in maintaining steady levels of budgetary spending.

Taking as a basis the data on monthly budgetary expenses published by The Fiscal Monitor, we examined the level of budgetary spending throughout the year for all surplus years. Our estimates show that average federal program spending occurring in the last third of the fiscal year (i.e. December – March) has constantly been higher than average spending experienced during either of the other 4 month periods of the year (i.e. April – November). This holds true even when March is excluded from the consideration as an atypical month in which spending is expected to be significantly higher.

If year-end program spending hikes, instead of being spent, would be directed towards paying the national debt, they could have contributed some $30 billion to that end over the last decade

During the first five surplus years, the average program spending that took place in December – February was more than 10% higher than the average spending for April – November. Starting with the 2002-03 fiscal year, the level of year-end hikes became less pronounced; however, it bounced back to as high as 11.3% in 2007-08 (top bar chart of Figure 10).

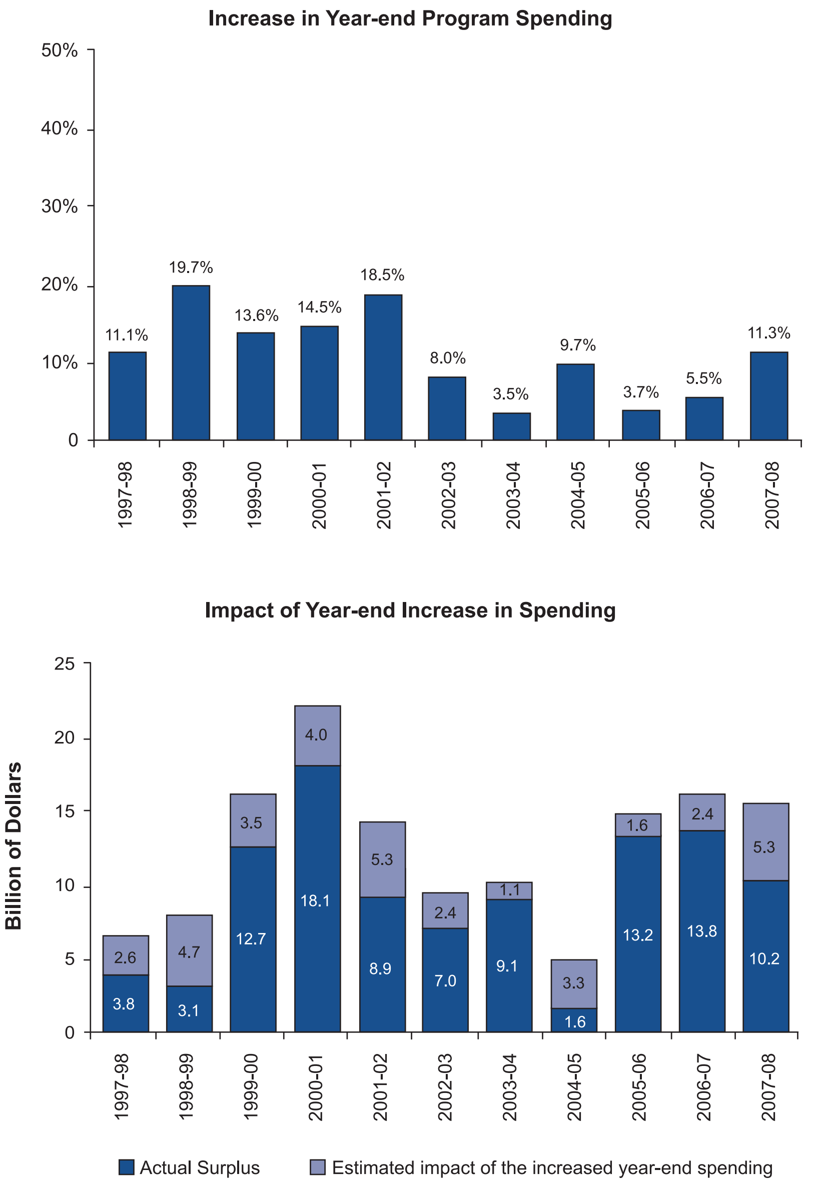
In the absence of the year-end spending hikes, the funds otherwise spent could have become part of the surprise surplus. The bottom bar chart of Figure 10 shows the dollar amount of the estimated impact of the end-year increase in spending. Keeping December – February program spending at the same level as in the first eight months of the fiscal year could, for instance, have added as much as $5.3 billion to the federal surplus in 2001-02 and another $5.3 billion in 2007-08, but that was already relatively unpopular at the time. Prompted by a demonstrated need, the preservation of funding allotments, or reinvestment of surplus funds, the point of the matter is that spikes in year-end spending are common; and do introduce some havoc in meaningfully evaluating or comparing spending.

Reducing public debt has become one of the fiscal priorities of the federal government. Starting from Budget 2004, the government set a numeric target of reducing the debt-to-GDP ratio to 25% and surprise surpluses have been routinely used for paying down the debt. If year-end spending hikes, instead of being spent, would be directed towards paying the national debt, they could have contributed some $30 billion to that end over the last decade. In fact, the targeted 25% debt-to-GDP ratio could have been achieved much sooner than

22 Department of Finance Canada (2006). *Annual Financial Report of the Government of Canada, Fiscal Year 2005-2006, p. 21.*

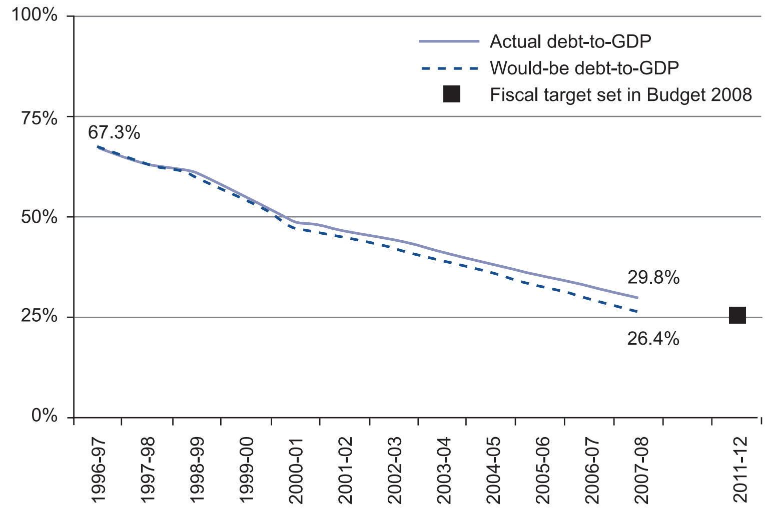
the currently projected 2011-12. Figure 11 reveals the estimated would-be debt-to-GDP ratio which could have been achieved if the year-end spending hikes had been permitted to flow through as surprise surpluses.

Figure 10 – Impact of the Year-end Increase in Spending



Source: The Fiscal Monitor, April 1997 to February 2008; Financial Fiscal Reference Tables 2002, 2005 and 2007; The Budget Plan 2008, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

Figure 11 – Potential Federal Debt Reduction[23]



Source: Fiscal Reference Tables 2007; The Fiscal Monitor, April 1997 to February 2008; The Budget Plan 2008, Department of Finance Canada; CANSIM Table 380-0017; CGA-Canada computation

As this section has confirmed, there are a number of negative implications associated with the surprise federal surpluses. Their very presence compels us to investigate the factors that cause surprise surpluses to occur or to reappear. For that reason, the following section is devoted to doing just that.

23 The would-be debt-to-GDP ratio shown on Figure 11 assumes that the annual debt reduction is composed from the potential federal surplus and savings on public debt charges. The potential federal surplus in a given year is estimated as a sum of the actual federal surplus and amounts of year-end hikes (i.e. excess of average program spending in December – February over the average program spending in April – November). Savings on public debt charges are estimated as a difference between actual public debt charges and the would-be debt charges which are a function of the would-be debt from the previous year. The would-be debt charges are estimated based on the interest rate paid on the actual public debt.

Main Causes of Persistent Surprise Surpluses

4

When speaking of the causes of federal surpluses, the distinction between the planned and the surprise constituents of surpluses becomes useful and central. For the planned component of the surplus, the answer to the question of causality is more than straightforward. The planned surplus is caused by a clear and open determination of the government to simply have it, which is also reflected in the term "planned".

For the surprise component of the surplus, the variety of causes that come to mind may vary from pure good fortune to favourable economic developments, to political will, to electorate pressure. However, one should be mindful of pitfalls of cause-effect relationship: the cause of a surprise surplus is always the same – inaccuracy of budget projections, whereas the causes of inaccurate projections may be diverse and changing over time. The pages to follow discuss these issues in greater length.

4.1. Inaccuracy of Federal Fiscal Projections

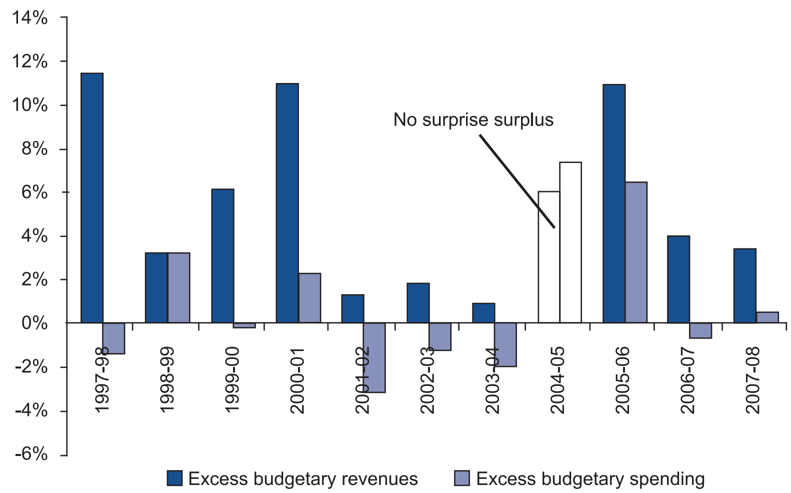
4.1.1. Budgetary Revenues and Expenses

When a surplus is not planned but comes as a surprise, it can only be caused by inaccuracy of budgetary assumptions or projections. Surprise surpluses appear when actual budgetary revenues and/or spending deviate from amounts projected in the budget. Although it may be tempting to assume that a surprise surplus would appear when the actual revenue exceeds the projected amount or when the actual spending falls short of projections, a simultaneous excess (or shortfall) in both revenue and spending may also result in a surprise surplus if the excesses/shortfalls are of a different magnitude.

The cause of a surprise surplus is always the same – inaccuracy of budget projections, whereas the causes of inaccurate projections may be diverse and changing over time

During the surplus years, actual budgetary revenues have always exceeded projected amounts. This was the case even in 2004-05 when no surprise surplus was recorded. However, the level of excess varied significantly over the years with no particular trend or constant towards, an increase, a decrease, or stabilization in the magnitude of the forecasting inaccuracy. Forecasting mistakes varied from nearly 11% of projected revenues in 2000-01 to less than 1% of the projected level in 2003-04 and to approximately 3% in 2007-08 (Figure 12).

Figure 12 – Difference Between Actual and Projected Federal Budgetary Revenues and Expenses



Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

Analogous to the budgetary revenues, the inaccuracy of spending projections does not show any particular trend over the surplus years. However, the inaccuracy of spending projections was positive in some years and negative in others, and the magnitude of error was somewhat lower than that for the revenue projections. Six out of 10 years of surprise surpluses saw actual spending fall short of projected levels (Figure 12). The shortfall was particularly noticeable in the 2001-02 fiscal year when actual federal spending fell short by 3.1% of the projected amounts. This was so despite the unfavourable economic conditions caused by the September 11 events and the capital market turbulences triggered by the Dot-com bubble burst in 2000. During the four years when actual budgetary spending exceeded the projected amounts, the level of excess differed significantly. The error was 3.2% of projected spending in 1998-99, exceeded 6% in 2005-06, and was only 0.4% in 2007-08.

Inconsistency in the forecasting inaccuracy does not allow for any conclusive certainty as to whether surprise surpluses were caused by excessive revenues or limited spending

Such inconsistency in the forecasting inaccuracy does not allow for any conclusive certainty as to whether surprise surpluses were caused by excessive revenues or limited spending. For instance, in 2001-02, the surprise surplus was mainly caused by lower than expected budgetary spending while in 2006-07, it appeared primarily due to higher than expected budgetary revenues.

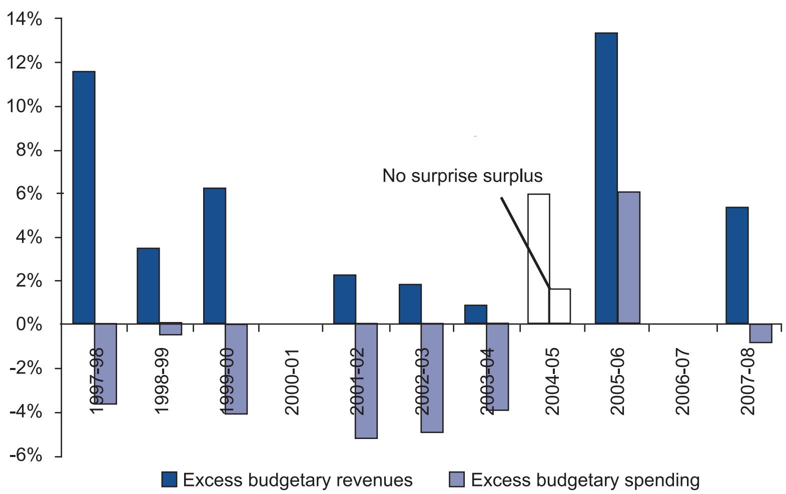
Moreover, during the surplus years, the federal government often introduced additional spending or tax measures as the fiscal year was unfolding. These in-year measures were not envisioned at the time of preparing the revenue and spending projections and thus were not reflected in the budget forecasts.

Among the most noticeable examples of such measures is the broad-based tax relief announced by the government in October 2007 and an increase in health care transfer payments made to provinces announced in fall 2004.

Such in-year adjustments mask the actual magnitude of the inaccuracy of the budgetary projections. For instance, unplanned tax reduction during the fiscal year will diminish the actual revenue for that year and may increase or decrease the inaccuracy of the revenue projections. Similar, launching unanticipated spending initiatives during the fiscal year may affect the difference between the actual and projected spending. When in-year policy measures are taken into account, the inaccuracy of budget projections becomes even more pronounced (Figure 13).

Cumulative surprise surpluses could have aggregated to at least $50 billion more than reported had no in-year policy measures been implemented

Figure 13 – Difference Between Actual and Projected Budgetary Components Adjusted for In-year Policy Initiatives

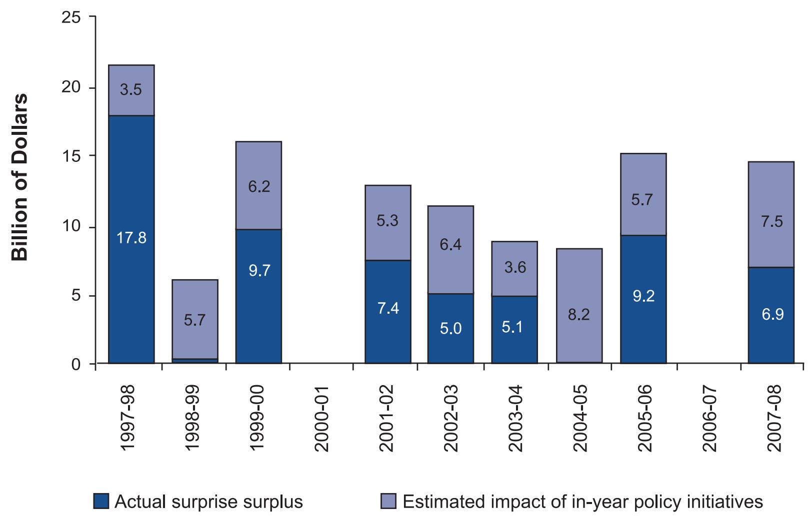


Note: 2000-01 and 2006-07 fiscal years are left blank as the budget documents do not provide a clear distinction between revenue and spending initiatives for those years.

Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

The changes to budget revenue and spending brought by unplanned in-year initiatives affect the level of the federal surplus and its surprise component. Our estimates show that cumulative surprise surpluses could have aggregated to at least $50 billion more than reported had no in-year policy measures been implemented. Moreover, the only one year when the federal government did not report a surprise surplus (i.e. 2004-05) would also have turned into a surprise surplus if the government did not increase spending in an unplanned manner over the course of that year (Figure 14).

Figure 14 – Actual and Potential Surprise Surplus



Note: 2000-01 and 2006-07 fiscal years are left blank as the budget documents do not provide a clear distinction between revenue and spending initiatives for those years.

Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

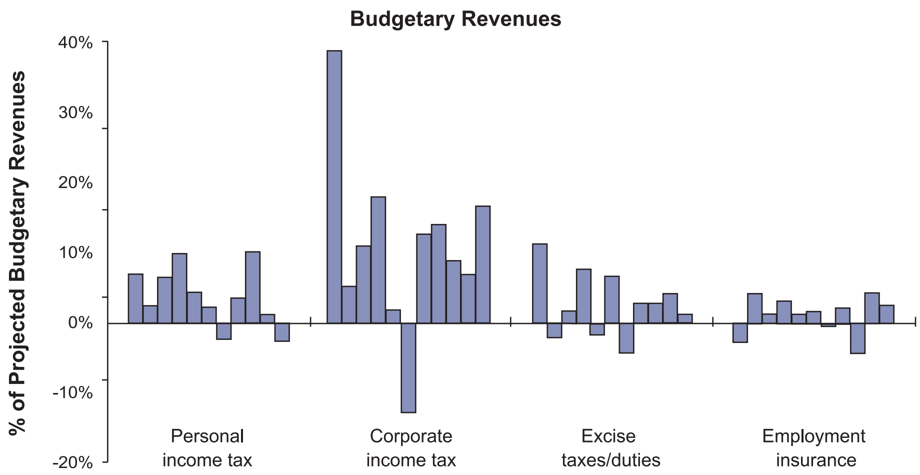
The in-year initiatives have been diverse in terms of policy focus, monetary size, and their impact on the budget; and judging their quality is beyond the scope of this paper. However, it is worth mentioning that the launch of these initiatives was often prompted by the anticipation of surprise surpluses. This renders the implementation of these important policy initiatives dependent on the anticipated existence and magnitude of surprise surpluses which, again ...... are theoretically not even supposed to appear.

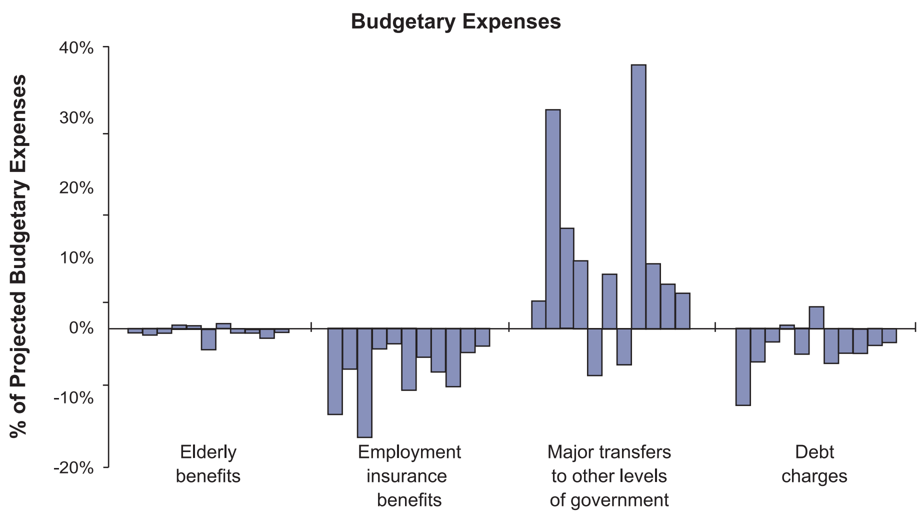
The degree to which different revenue and spending components contributed to overall forecasting inaccuracy is not constant

4.1.2. Components of Budgetary Revenues and Expenses

As evidenced above, the magnitude of forecasting inaccuracy for budgetary revenue and spending fluctuates significantly from one year to another. The degree to which different revenue and spending components contributed to overall forecasting inaccuracy is also not constant. For instance, actual revenues from personal income taxes often exceeded the projected amounts; however, to very different extents. The excess fluctuated from nearly 10% of the projected amounts in 2000-01 and 2005-06 to just 1% in 2006-07. Revenues from corporate taxes saw an even higher range of forecasting inaccuracy. They exceed the projected levels by 39% in 1997-98 fiscal year but only by 1.8% in 2001-02. The inaccuracy in projecting revenues from excise taxes and employment insurance premiums has been of a lesser magnitude than that for income taxes; however, have also been very inconsistent (top bar chart of Figure 15).

Figure 15 – Difference Between Actual and Projected Budgetary Revenues and Expenses, Selected Components, 1997-98 to 2007-08





Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

On the spending side of the federal budget equation, elderly benefits were the only item with fairly consistent forecasting accuracy over the surplus years. The inaccuracy of projecting other spending items was much higher. Employment insurance benefits and debt charges almost always fell short of projected amounts reflecting favourable economic conditions and decreasing interest rates. The forecasting accuracy of major transfers to other levels of governments seemed to be the most volatile spending item. The actual transfers to other levels of governments exceeded projections by some 31% in 1998-99 and 37% in 2004-05 fiscal years. At the same time, they fell short by more than 5% of projections in both 2001-02 and 2003-04 (bottom bar chart of Figure 15).

It should be noted though that the spending items discussed above represent only half of the total budgetary spending and thus do not portray the full picture of the forecasting accuracy. One of the main obstacles to a more thorough analysis lies in the fact that the reporting format of actual budgetary spending differs from the format in which projections are presented. For instance, all but one of the federal budgets tabled between 1997-98 and 2007-08 included projections for the direct program spending which accounted for nearly half of the total program spending. However, this item is not specified in the Fiscal Reference Tables or Public Accounts of Canada – the two principal publications that provide detailed information on the actual dollar amounts associated with financial activities of the federal government.

Moreover, the analytical challenges described in Appendix I cause further hesitation to reach a clear conclusion regarding the budgetary components that are the most challenging for the federal government to forecast. What is clear though is that the overall forecasting accuracy has been and remains far from being precise.

4.2. Factors Nourishing Inaccurate Budget Projections

A strong economy, small misses and no-deficit rule are believed to cause inaccurate budget projections

The federal government has examined the issue of its fiscal forecasting on a number of occasions. In 1994, the Department of Finance Canada commissioned an independent, external review of the Department's forecasting performance. A similar review was also conducted in 2005 whereas the documents accompanying Budget 2006 also included a brief narrative of the concerns posed by reappearing surprise surpluses.

Of these studies, the review conducted in 2005[24] contains a convincing arrangement of veracity and breadth of the analysis. The review was prompted by the persistent differences between the budget fiscal projections, and the final outcomes, and aimed to identify changes to the budget process that could improve forecast accuracy. Some 20 experts in forecasting and budget preparation were interviewed during the study. They represented private sector and university economists, other academics, staff advisors to political parties and former senior government officials. A quantitative analysis of forecast accuracy was carried out by an independent organization, while the International Monetary Fund contributed with a comparative analysis of the budgeting practices in Canada and other major industrialized countries.

The following factors were identified by the study as primary causes of inaccurate budget projections:

- "Several years in which economy grew larger than expected;"

24 O'Neill, T. (2005). *Review of Canadian Federal Fiscal Forecasting: Processes and Systems,* O'Neill Strategic Economics.

- "Small misses in forecasting revenue and spending can produce big errors in forecasting the surplus;"
- "Cautious fiscal forecasting that flowed directly from the government's determination never to run a deficit."[25]

The paragraphs that follow consider these factors in greater detail.

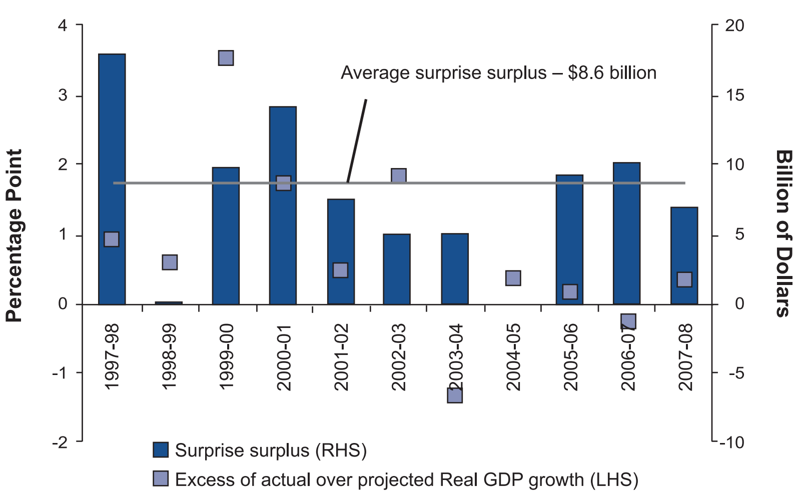
4.2.1. A Strong Economy?

As a general rule of thumb, a stronger than anticipated economic growth is expected to increase budgetary revenues through higher income and labour taxes and decrease budgetary spending through a reduced need for unemployment benefits creating, thus, the conditions for a surprise surplus. Over the surplus years, the actual economic growth (measured in terms of real GDP) indeed often exceeded the projected amounts that were used for budget forecasting. However, there was no straightforward relationship between the stronger than expected economic growth and surprise surpluses.

There was no straight-forward relationship between the stronger than expected economic growth and surprise surpluses

The 1999-00 fiscal year saw a large positive error in the economic forecast; however, the surprise surplus was just about the average. In 2003-04, a lower than expected economic growth was accompanied by a substantial surprise surplus, whereas relatively accurate projections of the real GDP growth in 2006-07 went in a tandem with an above average surprise surplus (Figure 16). Although the accuracy of economic forecasts has improved significantly over the past four years, it was not reflected in a similar improvement in the accuracy of budgetary forecasting.

Figure 16 – Budget Projections and Economic Growth



Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CANSIM Table 380-0017; CGA-Canada computation.
See Appendix I regarding the data accuracy.

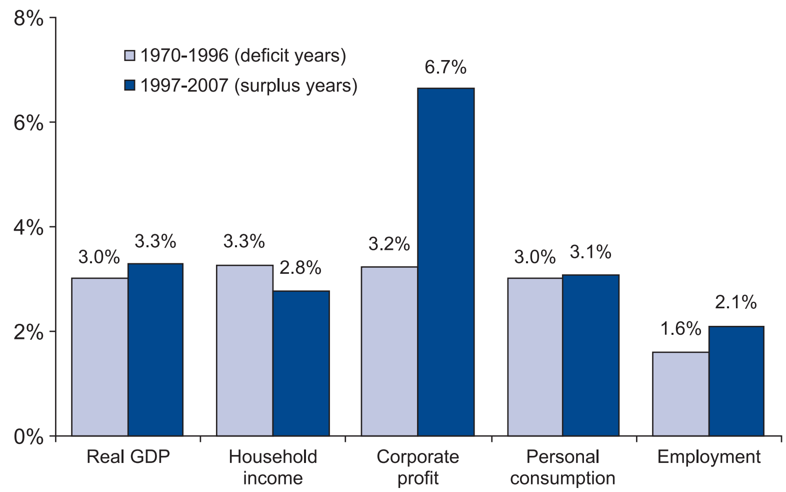
25 O'Neill, T. (2005). *Review of Canadian Federal Fiscal Forecasting: Processes and Systems,* O'Neill Strategic Economics, p. 24, p. 3 and p. 2 respectively

The performance of economic indicators that reflect the sources of budgetary revenues was not significantly better during the surplus years compared to the years with the federal budget deficit

In addition to the influence of stronger-than-expected economic growth, the federal surplus is often assumed to be a by-product of the generally strong economy that Canada has enjoyed in recent years.[26] The fact that budgetary revenues have always been under-estimated[27] may suggest that the elements feeding into the revenues (e.g. household income and consumption, corporate profit, etc.) enjoyed a particularly strong growth over the surplus years.

It is interesting to note, though, that the performance of economic indicators that reflect the sources of budgetary revenues was not significantly better during the surplus years compared to the years with the federal budget deficit. For instance, the average annual growth of real GDP was only somewhat higher during the surplus years, while household income grew at a slower pace during the surplus years compared to the years with budget deficit (Figure 17). For the sake of fairness, it should be noted that surplus years saw corporate profits growing twice faster than during the deficit times; however, on average, corporate income tax contributed only 14% to the total federal government revenues during deficit as well as surplus years.[28]

Figure 17 – Selected Economic Indicators - Average Annual Growth



Note: Household income, personal consumption and corporate profit are adjusted for inflation. Employment growth rate during deficit years is calculated based on 1976-1996.

Source: CANSIM Tables 051-0005, 282-0002, 326-0021, 380-0017, 380-0019, 380-0020, 380-0056, CGA-Canada computation

26 See, for instance, Organisation for Economic Co-operation and Development (OECD) (2006). *OECD Economic Surveys – Canada*, Volume 2006 Issue 10; Yalnizyan, A. (2004), *Squandering Canada's Surplus: Opting for Debt Reduction and "Scarcity by Design"*, Canadian Centre for Policy Alternatives; Offman, C. (2007). *Surplus Passes Projection by More Than 50%*, The National Post, September 28, 2007.
27 See Section 4.1.1 for more discussion regarding the forecasting accuracy of budgetary revenues
28 Department of Finance Canada. *Fiscal Reference Tables*, 2002 and 2007, CGA-Canada computation

4.2.2. Small Misses?

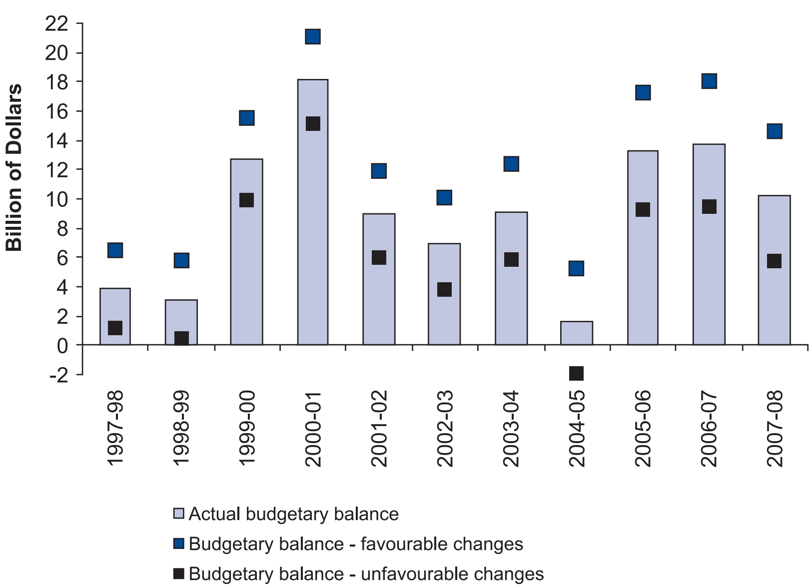
It is difficult to argue against the fact that simple arithmetic inflicts a significant influence on the level of the budgetary balance.[29] Derived as a difference between two numbers measured in billions of dollars, the budgetary balance may easily turn from surplus to deficit due to a small mistake in forecasting one of the budgetary components.

Figure 18 shows estimated level of budgetary balance assuming that budgetary revenue and program spending were slightly off compared to their actual amounts. We define "favourable changes" as a simultaneous 1% increase in budgetary revenues and 1% decreases in program spending, whereas "unfavourable changes" represent an opposite change – a simultaneous 1% decrease in budgetary revenues and 1% increase in program spending.

The budgetary balance may easily turn from surplus to deficit due to a small mistake in forecasting one of the budgetary components

If favourable changes in the budgetary components had occurred in 1998-99, they would have almost doubled the surplus reported in that year. Conversely, if unfavourable changes had taken place in 2004-05, the budget would have reported a deficit of some $2 billion (Figure 18). Also, as total amounts of budgetary revenues and spending increases in dollar terms, the influence of either favourable or unfavourable changes on the budgetary components becomes more noticeable. For instance, in 1997-08, favourable changes would

Figure 18 – Estimated Effect of Changes in Budgetary Revenues and Expenses



Source: The Budget Plan for corresponding years; Fiscal Reference Tables 2002, 2005 and 2007, Department of Finance Canada; CGA-Canada computation. See Appendix I regarding the data accuracy.

29 O'Neill, T. (2005). *Review of Canadian Federal Fiscal Forecasting: Processes and Systems*, O'Neill Strategic Economics.

increase the surplus by $2.6 billion while, in 2007-08 the same magnitude of favourable changes (i.e. 1% increase in revenues and 1% decrease in program spending) would increase the surplus by $4.5 billion.

It may be reasonable to assume that many other countries face a similar problem when small misses in revenue and spending forecasts result in much larger errors in the budgetary balance. However, Canada's forecasting seems to be more inaccurate than in other countries. A recent study conducted by the International Monetary Fund[30] compared accuracy of budget forecasting of 12 countries[31] and concluded that fiscal forecast errors are higher in Canada than in the benchmark countries. This is so even despite the fact that Canada's fiscal forecasting is "governed by one of the strongest institutional frameworks relative to benchmark countries."[32]

Canada's forecasting seems to be more inaccurate than in other countries

4.2.3. Fiscal Rules?

Fiscal rules are deemed to be successful in maintaining fiscal discipline as they are designed to keep certain budgetary indicators within set limits or levels.[33] Different countries apply different rules. For instance, the European Union requires that deficit and debt of each member country do not exceed specified proportions of GDP, Australia sets to have a balanced budget over the economic cycle, whereas the United States uses caps on discretionary spending. Generally, those fiscal rules that combine budget balance rules and expenditure rules are found to be more effective than those referring to only the general budget balance. A very broad formula for a successful fiscal rule is to be flexible enough to respond to the economic cycle but also be simple and transparent enough for managing, understanding and monitoring.[34]

Over the surplus years, Canada's fiscal rules have changed a number of times. Budget 1998 aimed to achieve the balanced budget over a two year horizon and a permanent, downward track of the debt-to-GDP ratio. In 1999, this fiscal target was replaced by a "balanced budget or better", whereas Budget 2004 added a specific numeric target for the debt-to-GDP ratio. It set to reduce the debt level to 25% of GDP by 2014-15. In 2006, the target for the balanced budget was silently abandoned while the goal of lowering debt-to-GDP ratio to 25% was advanced to 2013–14, and the subsequent budgets moved the debt target even closer to the present time.

30 International Monetary Fund (2005). *Canada: Selected Issues*, IMF Country Report No. 05/116.
31 The benchmark group consisted of G7 countries, Australia, New Zealand, Netherland, Sweden and Switzerland
32 International Monetary Fund (2005). *Canada: Selected Issues*, IMF Country Report No. 05/116, p. 45.
33 Andrés, J. and Doménech, R. (2006). *Fiscal Rules and Macroeconomic Stability*, University of Valencia, Hacienda Pública Española, 176-(1/2006), 9-42.
34 Guichard, S. et al. (2007), *What Promotes Fiscal Consolidation: OECD Country Experiences*, OECD Economic Department Working Papers, No. 553.

The study discussed at the beginning of this section (Section 4.2) concluded that establishment of a no-deficit rule (or "balanced budget or better") prompted the government to incorporate an implicit caution in the budget forecasting which served as an additional safeguard to already existing explicit caution in the form of Contingency Reserve and Economic Prudence. It was suggested that the implicit caution was driven by a much higher political cost that may be associated with a small budget deficit compared to a much lower costs of a large surprise surplus.[35]

In 2006, the Conservative federal government admitted that larger than projected budget surpluses had "eroded the credibility of the budget process and limited the scope of parliamentarians and Canadians to debate alternative uses of surplus funds".[36] Responding to these concerns, the federal government adopted a new approach to budget planning and fiscal forecasting that included the following:

- The practice of adjusting the budget projections for economic prudence was discontinued; Contingency Reserve and Economic Prudence were no longer incorporated into the budget, whereas a planned debt reduction of $3 billion a year was introduced.
- Budget projections continued to be based on the average forecast of private sector economists, whereas the economic and fiscal projections of the budget were to be presented over a two-year time horizon in order to allow higher accountability of the government.[37]

Moreover, if in the late 1990s and early 2000s the government was open about not being "prepared to risk a return to deficits";[38] similar statements are no longer found in today's government documents and speeches. However, as was seen in Section 2.3, substantial surprise surpluses were reported in both 2006-07 and 2007-08 fiscal years and seem to be just a continuation of the surplus practice started in the late 1990s.

Furthermore, the federal government identified the reduction of total government's net debt as one of Canada's competitive economic advantages and committed to reduce it to zero in less than a generation.[39] The total government consists of federal and provincial-territorial governments, whereas total government's net debt is a combination of net debts of these governments. A commitment to achieving something which is not fully under federal government's control may create an additional pressure for overachieving on the component which is actually controlled by the government, namely the federal public debt.

A commitment to achieving something which is not fully under federal government's control may create an additional pressure for overachieving on the component which is actually controlled by the government

35 O'Neill, T. (2005). *Review of Canadian Federal Fiscal Forecasting: Processes and Systems*, O'Neill Strategic Economics, p. 28 and 73.
36 Department of Finance Canada (2006). *The Budget Plan*, p.53.
37 Department of Finance Canada (2006). *The Budget Plan*, p. 53.
38 Department of Finance Canada (2000). *The Budget Plan*, p. 45.
39 Department of Finance Canada (2006). *Advantage Canada – Building a Strong Economy for Canadians*, p. 29.

There is hardly a doubt that surprise surpluses become a great help to the federal government in delivering on its promise in achieving the fiscal advantage

Although a planned debt reduction has recently been incorporated into the budget projections, the history of the surplus years shows that surprise components contributed some 67% out of the total of $105.8 billion debt reduction that took place between 1997 and 2007. Moreover, in 2006 and 2007, the federal government planned to reduce public debt by only $6 billion, while thanks to the large surprise surpluses the debt repayment in those two years was supplemented by an additional $17.1 billion. There is hardly a doubt that surprise surpluses become a great help to the federal government in delivering on its promise in achieving the fiscal advantage.

Summing up the discussion, federal budget projections have been and remain somewhat inaccurate. This is so for the budgetary revenues and expenses, but also for the different components that make up revenue and spending. Canada's strong economy – a frequently assumed cause of surprise surpluses – does not seem to be the decisive driving factor of the forecasting inaccuracy. Similarly, while all countries face the same problem of "small misses", Canada's forecasting accuracy is worse than that of other countries. This leads to a conclusion that the invisible political pressure to avoid deficit may still play a very important role in shaping surprise surpluses.

Closing Comments

5

It is not for nothing that public policy deliberation is called a “debate”. Unlike areas where science may provide solid guidance for distinguishing between alternate states and identify the most effective and efficient solutions leading to optimal outcomes, there is no absolute accuracy in virtually any area of the public policy. Economic and social studies depend heavily on the assumptions employed and there are numerous examples when similar research questions lead to conflicting conclusions. The pressure applied by different interest groups is, by definition, focused on the interests of those specific groups. Electorate pressure, in turn, may not reflect the very best approach in terms of the economic efficiency or social fairness, but is a very strong determinant in forming public policy.

Federal fiscal and budgetary policy is a highly visible subject of the public policy debate, but it is also a particularly delicate area. Virtually any economic agent, be it an individual, an enterprise, an industry or a jurisdiction, may have something to gain or to lose from even minor changes in fiscal policy. Our position may also depend on the hat we wear and the timeline that we embrace. As responsible individuals, we may be compelled to oppose the cut in the GST knowing the economic consequences of such a measure, but as household constituents, we may well enjoy paying lower taxes at point of retail sale. Similar, the technicalities of collecting budget revenues and managing program spending are not always well understood by the outsiders to the budgetary process. This may lead to wrong conclusions on what is possible or impossible to implement. The complexity and multi-faceted character of the fiscal policy creates certain limitations to the objectivity, accuracy and encompassing quality of any research in this area.

Recognizing these limitations, we would concentrate on desired attitudes towards the federal budget and budgetary balance.

It is interesting how the meaning of words changes over time. A call for a balanced budget in the mid 1990s was definitely associated with a request to eliminate the budget deficit. Conversely, in the late 2000s, the same call conveys a request to abolish the practice of continuously reappearing surprise budgetary surpluses.

When a planned surplus is incorporated into the budget projections, its purpose is also assumed to be known. When a surprise surplus appears, it brings up a debate on the ways to spend it. Although the choice of alternatives may seem to be diverse, it eventually narrows down to three possibilities: increased spending, reduced taxation or repayment of the public debt.

Any of these options may be supported by solid arguments; however, one major difference between them exists: paying down public debt may be viewed as honouring an already incurred liability, whereas reducing taxes and/or increasing program spending is a policy decision associated with **new liabilities**.

Although federal surprise surpluses have been appearing regularly, their level and presence in each fiscal year remains uncertain. It then seems to be particularly worrisome that diminishing government's revenue capacity or increasing spending commitments may be based on something which may or may not materialize in the future.

Using surprise surpluses for paying down debt may then emerge as the most neutral option. If no surprise surplus appears, the debt status quo remains unchanged, while a positive surprise surplus will bring benefits associated with the debt reduction and it may well be justifiable to dedicate as much as 1% of GDP (the size of the federal surplus in 2005-06 and 2006-07) to this purpose.

The relentless endeavour for debt reduction may suggest that public debt is a matter best to be avoided. The most often cited negative implications of the public debt are decreased national savings which lead to increased net foreign indebtedness and a lower capital stock due to high risk premium on interest rate and lower private consumption. However, several benefits of having public debt have also been identified. It is believed that the government debt can enhance the liquidity of households by providing relatively safe saving instrument, increasing private net asset position and easing borrowing constraints.[40]

Economic literature offers limited clarity on the optimal level of debt. One of the extreme theories suggests that the size of the debt does not impose any consequences on the allocation of resources as long the debt is either stable or grows at a sustainable pace. A more moderate approach recommends keeping tax rates relatively constant over time and adjusting the debt level in a way that allows achieving this objective. Another theory focuses more on intergenerational fairness and implies that the size of the debt should be chosen in such a way as to distribute the burden evenly across generations.[41]

40 James, S. and Karam, P. (2001). *The Role of Government Debt in a World of Incomplete Financial Markets*, Department of Finance Canada, Working Paper 2001-01.
41 International Monetary Fund (2000). *Canada: Selected Issues*, IMF Staff Country Report No. 00/34.

Given the complexities and importance of the decisions related to the possible use of the excessive fiscal room, would not it be better to contain this debate within the general budgetary process rather than on a year-by-year bases depending on the size of the surprise surplus?

The federal budget is largely a function of the national and global economic growth, changes in world prices and developments on the international financial markets. In the same way as we are accustomed to fluctuating business cycles, we must likewise allow the notion that government's budgetary balance may also fluctuate. Although the balanced budget should be the focus of the government's efforts, it cannot be truly achieved without allowing for a risk of deficits as well as surpluses.

Our greatest parting advice is for the government to resist tinkering. While at time of writing, there is a risk that the government could find itself in a deficit within a couple of years, CGA-Canada would caution against balancing the budget at all costs. Raising taxes or curbing spending would in our view exacerbate the very triggers that might cause a deficit to begin with. And while it is not our preference, Canada would have little difficulty in borrowing money if ever the fiscal drain envisioned by some was to be faced. The fact of the matter is that the planned surplus course should not be altered to accommodate current indicators. Low stable inflation, dropping interest rates and anticipated growth in the economy combined with the mix of Canada's CPI basket make any dramatic changes premature even in light of rising food and energy costs.

And while some continue to be adverse to surprise surpluses, our advice is to celebrate in those triumphs with a view to optimizing debt decline.

As an accounting association, we are naturally attracted to the prospect of eliminating debt for the benefit of current and future stakeholders. We are also more prone to controlling expenses with a view to investment and renewal and prescribing tax revenue models which are most efficient (consumption) over those which tax capital investment, innovation and productivity (capital, income and sales).

More than ever, Canada must look at the economic long term. That long term view looks to stabilization of the government tax base, responsible and efficient program delivery and a continued diligence in drawing down the debt; both with dedicated planned surpluses and with surprise surpluses when they surface. This calls also for a culture of responsibility as the electorate places enriched reliance on government for programs and services; especially in these times of surplus.

Government is a business and we need to allow it to be managed accordingly. This calls for exhaustive budgeting and monitoring and also commands regular forecasting for sake of corrective adjustment. All the while, Canadians want some degree of constants and consistency. To that end, we are hopeful that the right budgetary balance can be struck and that the budget process can be improved to the extent possible. Due diligence and objectivity are being asked from across government and we are confident that new measures such as those introduced under the Federal Accountability Act can contribute. Specifically, the appointment of a Parliamentary Budget Officer to provide independent analysis on the state of the nation's finances and the clarification of the responsibilities of deputy ministers in relation to accounting and internal auditing in federal government departments are welcomed. Taken also with other enforcement measures introduced by the Act, the potential is there to enhance accuracy and accountability. So back to the question at hand, yes as we have entered the 21st century, the whole vernacular of surprise surpluses may in fact have morphed into a more modern device of conservatism. Within that new paradigm and in a stable economy, that new characterization fundamentally persuades federal surprise surpluses to serve as both a surprise and as an instrument of strategy.

Appendix 1: Technical Note on Comparing Historical Data from Government Financial Statements

6

Over the surplus years, the federal government has introduced a number of changes to the way that federal finances are accounted for and reported. Below, we present the list of changes as well as the implications that they have imputed to the analysis presented in this paper.

Changes in accounting policies and reporting format

The changes in the accounting policies and reporting format have been of a different magnitude ranging from revising some definitions to changing the whole accounting framework; however, for easier navigation, the list of changes presented below is in chronological order.

1997-98 fiscal year: The government changed its method of accounting for assistance to international financial institutions, and calculating interest costs on obligations for public sector pensions. Under the new accounting rules, an expenditure is recorded when a note payable is issued to an international financial institution rather than when it is redeemed. Calculation of interest charges became based on the actuarial obligations rather than superannuation account balances.

2003-04 fiscal year: The government changed its basis of accounting from modified accrual to full accrual. Under the full accrual accounting standard, transactions and other events are recognized when they occur and not when cash is received or paid. This is believed to make financial results more reflexive of economic developments, and changes in the tax base and government actions undertaken during the fiscal year. The change of the accounting standard brought the following major modifications:

- Tax receipts and refunds are now recorded in the year in which the taxable activity takes place. Previously, tax revenues were recorded in the year they were received.
- Non-financial assets are now included in the government's balance sheet. Previously, the value of the government's stock of capital assets was not shown on the balance sheet.
- The annual cost of owning a capital asset is now estimated as depreciation in the value of the asset. Previously, the full purchase price of a capital asset was shown as an expenditure item in the year of purchase.

- The list of liabilities is now extended to include cost of environmental clean-ups of federal properties, increased liabilities for post-employment benefits for federal employees and some other liabilities.

2005-2006 fiscal year: The government revised the definition of reporting entity. The revised standard removed the criteria of accountability to and ownership by the government and expanded the definition of control. As a consequence, some organizations that were previously not part of the government's reporting entity have been included in the financial statements.

2006-2007 fiscal year: The government modified the rules of recording other comprehensive income of Crown corporations. It is now excluded from the corporations' net income. In addition, the government adopted the practice of presenting financial information in the budget and annual reports of fiscal outcomes on a gross basis. Previously, budget forecasts and fiscal outcomes were published on a net basis where certain disbursements were netted against budgetary revenues and certain revenues were netted against expenses.

Analytical challenges caused by the accounting changes

For the purposes of this paper, the revisions to the accounting policies and reporting formats pose two broad analytical challenges. The first relates to analysing the historic trend of the budgetary balance, whereas the second poses difficulty in assessing accuracy of budgetary projections.

Historic trend. The Fiscal Reference Tables published by the Department of Finance Canada provide historic information on the financial position of the federal government and cover the period between 1946-47 and 2006-07 fiscal years. Due to the changes in the accounting standard from modified to full accrual, the data in the Fiscal Reference Tables were revised to allow for compatibility of historical comparisons; however, the revisions were only made back to the 1982-83 fiscal year. This means that published data for the years prior to 1982-83 are not directly comparable to more recent years. Figure 1 in particular is affected by this difficulty. However, because the purpose of Figure 1 is to show the general trend across the years rather than the more precise levels of budgetary balance in each fiscal year, liberty has been taken to combine on one chart the data based on modified and full accrual accounting.

Accuracy of budgetary projections. Each year, the federal budget (as well as budgetary projections) is presented based on the accounting policies available at the time of presentation. The actual dollar amounts of the budgetary components are published approximately 1.5 years after the projections were first presented and may already be presented under different accounting rules. Within the timeframe considered in this report (i.e. from 1997-98 to 2007-08 fiscal years) the following factors affect the accuracy of comparing projections to the actual budgetary outcomes:

- Projections for 2001-02 fiscal year were presented in December 2001, when nearly three quarters of the fiscal year were already over. In this way, the projections were largely based on already known actual amounts.
- Projections for 2002-03 fiscal year were based on the modified accrual accounting framework whereas the actual data for that year are available on full accrual framework only.
- Projections for 2005-06 fiscal year were based on a net basis whereas the actual data for that year are available on gross basis only.
- The layered nature of changes in accounting rules and presentation format does not allow for the use of one single source of data on actual budgetary outcomes.

Charts presented in Figure 3, 8, 10-14 and 16 of this paper have been affected by these difficulties. To mitigate these difficulties to the extent possible, the following combination of data sources was used.

Variable	Data Source
Budgetary projections for 1997-98 – 2001-02 and 2003-04 – 2007-08	The Budget Plan for corresponding years
Budgetary projections for 2002-03	The Budget Plan 2001
Actual fiscal outcomes for 1997-98 – 2001-02	Fiscal Reference Tables 2002 (the latest publication where budgetary data are presented on modified accounting basis)
Actual fiscal outcomes for 2002-03 – 2004-05	Fiscal Reference Tables 2005 (the latest publication where budgetary data are presented on a net basis)
Actual fiscal outcomes for 2005-06 – 2006-07	Fiscal Reference Tables 2007
Actual fiscal outcomes for 2007-08	The Budget Plan 2008

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